VALUATION OF LEASEHOLD PROPERTIES FOR LESSOR OR LESSEE

BY R.K.GANDHI. MUMBAI.

1.00 In a Property Valuation Dispute case , a Valuer of claimant was appearing before Arbitral Tribunal headed by three Supreme Court Judges, MR. Krishna Iyer J, MR. S.N. Variava. J. & MR. Jhunjhunwala J. In cross examination, Respondent's counsel asked the question : MR. Valuer, in your valuation report you have considered value of Lessors interest at only 1% of total Land value, where as in case of Ajitsingh (1997 – 6 –SCC-50), Supreme Court has approved 40% as share of Lessor in Land Value. What have you to say about this judgement and share of Lessor in total value of land ?

Experienced valuer replied : "After going through the judgement ,I have to say that Supreme Court's view in this judgement is erroneous because several relevant technical & legal aspects are not considered by the court before forming an opinion that Value of Lessor's interest in land was 40 % of the total value of land." Valuer further stated that points not considered by the court are as under.

(i) What is the total period of Lease and what is unexpired period of Lease ?

(ii) Whether Lease is renewable for further term OR on maturity of lease period the property would revert back to Lessor ?

(iii) What is covenant concerning status of building erected on the plot ? At the time of maturity of Lease period , the Building on plot will have to be demolished or retained and handed over to the Lessor ?

(iv) What Lease rent is payable by the lessee for use of land and whether there is a provision for periodical increase in lease rent ?

(v) In case of renewal of lease , what will be the lease rent for the 2^{nd} period of lease ? Will lease rent be same as for 1^{st} period or revised rent for the 2^{nd} period will be based on prevalent market rent on date of maturity ?

(vi) If on maturity building vests with lessor, will it be free of cost or on payment of depreciated cost of building ?

(vii) What amount is payable to lessors (Unearned Increase Premium) in case of Transfer / Assignment of the property during lease period ?

After dictating valuer's full answer , Presiding Arbitrator Judge halted further cross and started discussing with other 2 judges. No one knew why cross was halted and what judges were discussing. Valuer however was smiling because he could guess very well what was happening. Three judges were perhaps telling each other that no one in their life has ever told them that these seven points were required to be considered before fixing value of lessor's share and value of lessee's share in a property.

1.10 Friends , there is nothing to laugh at these judges. They are not supposed to be expert on Valuation of leasehold properties. We valuers are supposed to be expert. Before criticizing the judgement , we must understand that Real fault lies with us , practicing valuers . It was the duty of Practicing Valuers appointed by the rival parties for technical advice, to bring to the notice of the court that at least these seven points must be examined before forming an opinion on value of leasehold interests of rival parties. Expert valuer's duty is to assist the court on Technical points .

1.20 In Ajit Singh's case S.C. held 40% share of lessor & 60% as share of lessee. In Bipin Kumar's case of 2004, S.C. held 25% share of lessor & 75% share of lessee. In case of Indraprastha Ice & Cold Storage Ltd, Delhi Bench fixed Lessors share at 87.5 % (7/8) and Lessee's share at 12.5 % (1/8)of land value. In number of S.C. cases this proportion went on changing.

In a very recent case of Sushila Patel V/s Ahmedabad Municipal Corporation (C/LPA/10/2014 decided on 30-9-2014, Supreme Court modified share of Lessor and Lessee without giving any technical reasoning. AMC and Gujarat High court had awarded 75 % of land value as compensation to Lessee (Sushila Patel) and 25 % share in land value as compensation to Lessor (State Government) . Supreme Court fixed this share as 50% to Lessor and 50% to Lesseee without assigning technical reasons. Lease was for 99 years period and had matured and land was acquired for road widening by A.M.Corporation.

All these decisions are adhoc & arbitrary because they are not backed by any technical calculations or based on expert valuer's opinion but are based on claim and views of litigating parties and submissions and arguments made by their lawyers.

1.30 A valuer was once called by chief accountant of a multinational company for revaluation of companies assets. Valuer asked for land documents. Chief said : Land is of leasehold tenure from state government and that land need not be valued being leasehold.

Valuer had great difficulty in convincing chief that company held substantial interest in land value in form of lessees interest in land value .Valuer further clarified that the Lesees interest in land will fetch substantial value in open market when property is sold.

1.40 A well known industrialist called valuer to estimate value of his factory and land where he was making net profit of Rs. 15 Lacs / year. After going through documents the Valuer said : Value of the property to you is zero because land was on 30 year lease and said lease period has now expired. There is no renewal clause in agreement and hence existing factory now belongs to lessor & not to you (lessee industrialist).

1.50 All these examples, indicates that there is tremendous ignorance about value of Rights of Lessor and Lessee in a Leasehold property. Ignorance on this issue is widespread even with valuers. It is very likely that some of our valuer friends present here were not aware of the fact that these seven points are vital for fixing value of leasehold interests of Lessor and Lessee in a leasehold property . Judges, Lawyers, Chartered accountants , industrialists , investors , property owners and some of our valuer friends must be educated by explaining them the relevant technical points involved in valuation of leasehold interests.

2.00 In order to understand the valuation of interests of a person in leasehold land, we will have to go to the basics. We must first understand different types of leases, lease terminology and interpretation of the provisions and clauses in different types of leases.

2.10 Land ownerships are basically of two types. Freehold Land and Leasehold land. Freehold ownership is highest form of property rights. However in case of leasehold property , ownership rights are divided between two parties viz. Lessor and Lessee . Hence we may say that it amounts to duel ownership. In case if property is subleased, there will be three parties holding interest in the same property, viz. Head Lessor, Lessee and Sublessee. Value of their respective rights will depend on lease terms , conditions and covenants.

3.00 Under section 105 of Transfer of Property Act, LEASE is defined as : Transfer of a right to enjoy such property, made for a certain time, express or implied or in perpetuity, in consideration of a price paid or promised, or of money, a share of crops, service of any other thing of value, to be rendered periodically or on specified occasion to the transferor by the transferee, who accepts the transfer on such terms.

3.10 Lease contracts is executed between Land Owner (Transferor) and Land Tenant (Transferee). Land owner is called the ‘Lessor’ where as land tenant or the land occupant is called the ‘Lessee’. Sometimes the property is sub leased. In such a case, land occupant is not called Lessee but is called ‘Sub Lessee’. Price paid (Consideration) is called ‘PREMIUM’ and the money to be rendered is called “Lease Rent” or Ground rent.

Rights of different interest holders in leased property are as under :-

Lessor : He is the owner of the land or land with building. He gives away possession (Transfers) of his property for use of tenant (Lessee), on rent and on certain terms and conditions. Lessor holds right to receive ground rent and right to reversion of land.

Lessee : He is the tenant of the property of Lessor. He holds occupational and developmental interest in leased out property, in accordance with the terms and conditions set out in the lease agreement. Lessee has right to erect buildings on plot and right to receive rent from such buildings.

Sub Lessee : Sometimes under lease agreement rights are given to Lessee to sub let the property to third person. This sub tenant is called Sub Lessee. Main Lessor in such a case is called Head Lessor. Right of Sub Lessee is similar to Lessee i.e. to erect building and to receive rent from the building erected on the plot.

3.20 There are basically four types of lease.

(i) Building lease. (ii) Occupational lease.

(iii) Sub Lease. (iv) Lease for Life.

3.30 Building Lease : This type of leases are most common in which open land is given on lease for construction of a building. Lease period may be 30 years, 40 years, 60 years, 99 years or 999 years. Lease period of 99 years or 999 years is called ‘Perpetuity’ (For ever) OR Perpetual lease. In this type of lease (Building leases) , ground rent for land usage is paid by Lessee to Lessor and rent from occupants of the building erected on the plot is received by the Lessee (Land tenant).

3.31 Many a times, in addition to annual ground rent, Lessor takes initial premium from the Lessee. This is like an advance lease rent for full period of lease. Annual lease rent in such cases is reduced correspondingly. In Government agency lease, such as M.I.D.C./ G.I.D.C. lease, full premium amount is initially charged and annual lease rent is fixed at token sum of Rs.1/- per year only. However in private leases total rent is bifurcated in two parts. Advance rent (Initial premium) and annual rent.

3.32 Some of these leases have a provision or clause for renewal of lease period for the second term. If first term is for 99 years, it is renewed for further term of 99 years at revised rent or same rent. In some other lease, there is a clause which requires surrender of building constructed on the plot by the Lessee to the Lessor, free of cost, on maturity of lease. Value of rights of Lessor and Lessee would all depend on these clauses and terms of lease.

3.40 Occupational Lease : This lease is for use (Occupation) of land and building together. Building is erected by Lessor on the land owned by him and then it is leased together for occupation of Lessee. Ownership of land and building are both with the Lessor . Occupational lease can also be in form of leasing of ownership flat, ownership office or ownership shop which belong to lessor but is leased to lessee for occupation. This type of lease is very common in all cities of India. Lease of ownership premises are rented out for short term period of 3 years, 5 years or 10 years. There is generally a provision of increase in rent after one year or two years interval. In India these types of leases are less for residential premises due to fear of Rent Control Act. Flat owner prefers to give flats for occupation on leave and license basis which is under Easement Act and no occupant can claim protection under Rent Act. However some flat owners do grant occupational lease (Company lease) of flats to reputed limited companies. Occupational lease of the commercial premises is very common in all parts of our country. It is normally under Transfer of Property Act.

3.50 Sub Lease : In this type of lease, Lessee has right to sub-let property as per terms of lease agreement. Lessee therefore grants sub-lease for a period which is one year less than period of main lease. If main lease is for 99 years period, sub-lease period will be fixed at 98 years . Again lease rent fixed under sub-lease is always more than the lease rent payable by Lessee to the Head Lessor under principal lease. Profit rent benefit is enjoyed by the Lessee. Under sub-lease, possession of property is with Sub Lessee only, yet there are three parties interested in the total value of the property viz. Head Lessor, Lessee and Sub Lessee. Value of rights of each one will depend on rental value and terms of principal lease and sub-lease.

3.60 Lease for life : Under this type of lease, period of lease is directly linked (co-terminus) with the future life span of the Lessee. On the death of Lessee the lease comes to an end. This type of lease is not common in India.

4.00 Terms – Conditions – Covenant : There is always a clause in all types of lease that if Lessee commits a breach of any of the terms and conditions of the lease, the lease would be determined (terminated) by the Lessor immediately i.e. before maturity date of lease. It is therefore necessary for a valuer to study various types of terms and conditions normally provided in lease document.

4.10 Some of the important terms and conditions normally stated in lease agreement are as under :-

Lease Term : Date of commencement and date of termination of lease.

Renewal Clause : Date of notice for renewal, first term in number of years and renewal period if any, and provision of revision of rent for renewal.

Amount of Rent : Fixed Annual Rent or monthly rent or ground rental i.e. increased rental after fixed period of intervals, say 10 years or 20 years.

Lessor's Covenant : Responsibility of land tax payment to the Government.

Lessee's Covenant : Payment of building tax, building insurance, repairs and upkeep of property, timely payment of lease rent.

Right for Assignment : Right to sub-lease the property, on condition or without any condition.

Restrictive Covenant : Not to alter building or change user of the land.

Vesting Back Land Clause : This is a very important clause Under this clause it is provided that the Lessee would, on maturity of the lease period, demolish the building erected on the Lessor's plot and would handover possession of open vacant land back to the Lessor . Many leases provide that on maturity of the lease the lessee would hand over or return land to the Lessor along with the building free of cost to the Lessor . There could be a provision that the Lessee would surrender back land with building to the Lessor but Lessor will be required to pay mutually agreed amount (Depreciated cost of building) to the Lessee for the building.

5.00 Depending upon lease conditions, value of interest of Lessor and Lessee would change.

5.10 <u>Value of Lessor's interest in property normally consists of two parts.</u>

(a) Capitalised value of ground rent income for unexpired period of lease.

(b) Present value of the right of reversion of the property (Land or land with building) at the expiry of lease period.

5.20 <u>Value of Lessee's interest in the property may consist of one or two parts.</u>

(a) Capitalised value of net rental income receivable from the building, for unexpired period of lease. As Lessee would lose the building on maturity, provision for recoupment of capital invested in building should also be made by selecting dual rate table.

(b) If the plot is not fully developed but is underutilized, in such a case, the Lessee would also hold interest equivalent to the present worth of the unutilized FSI land.

6.00 Value of right of Lessor Or value of right of Lessee are both worked out by Income Approach i.e. by application of Investment Method or Rental Method of Valuation.

6.10 The basic principle operating behind the Investment Method is that the property is capable of generating Income for long time in future owing to its durability and the Prudent Investor in the Real Estate Market desires a reasonable return on his capital Investment in an Immovable property. Thus there is a direct relation and link between annual income from the property and the Capital Value of the property. This is the basis of Investment Method of Valuation of the property.

6.20 Following examples would explain how value of the rights of Lessors and Lessees has to be estimated in case of leasehold property.

6.30 <u>Example-1</u> : M.I.D.C.(State Government Corporation) leased 1800 Sq.Mts. land for industrial use in 1976 by charging full premium at the rate of Rs.400/SM. Lease period was 95 years renewable for further 95 years period. Lease rent was fixed at Re.1/Year. Lessee constructed factory building (Area 950 Sq.Mts.) in 1976. Lease provides that in case of Sale (Assignment), Lessee shall pay 10% of unearned increase in land value to Lessor. Calculate value of right of Lessor and Lessee as on 2015, if replacement cost of factory in 2015 is Rs.15000/Sq.Mt. and land value in 2015 is Rs.5,000/Sq.Mt.

Solution : (A) Value of Lessor's interest : There is no right of reversion of land and factory building to Lessor M.I.D.C. for long period. This case is of Lease of land owned by State Govt. Due to renewal clause, it is a perpetual lease and reversionary value of land will be negligible. The lease rent is only Re.1/Year and hence its capitalized value also will be negligible. Lessor's interest in land value would be therefore restricted to claim of 10% unearned increase in land value in case of sale or assignment.

Unearned increase = 1800 x (5000 – 400) = Rs.82,80,000/-

Value of Lessor's Right = 0.10 x 82,80,000 = Rs.8,28,000/- … (a)

(B) Value of Lessee's interest :

Total value of land = 1800 x 5000 = Rs.90,00,000/-

Value of Lessee's interest = Total value of land – Value of Lessor's interest.

= Rs.90,00,000 – Rs.8,28,000 = Rs.81,72,000/- … (b-1)

Lessee also holds interest in Building Value .

Replacement cost of factory building :

950 Sq.Mts. @ Rs.15000/Sq.Mt. = Rs.142,50,000/-

Depreciation for 39 years age = 0.9 x 142,50,000 x 39 / 60

= Rs.83,36,250/-

Depreciated value of factory in 2015 :-

= Rs.142,50,000 – Rs.83,36,250 = Rs.59,13,750/- … … (b-2)

Value of Lessee's interest in property (b-1) + (b-2) :

Rs.81,72,000 + Rs.59,13,750 = Rs.140,85,750/-

Say Rs.140,86,000/- … … (b-3)

It will be seen that in this case, value of Lessor's interest is hardly 5.55% and value of Lessee's interest in property is 94.45% of total value. It will also be seen that Lessee's interest in Land has higher value than value of building. This is because of renewal period of further 95 years at token Lease rent of Rs. 1/year. If value of Lessees interest in land is ignored, value of property will drastically fall.

6.40 Example-2 : Under a private lease, 1500 Sq.Mts. land was leased in 1970 for a period of 70 years with lease rent of Rs.4000/Year. Lessee constructed a residential building and rented out tenements to tenants, which yielded net rental of Rs.50,000/Year. Calculate value of Lessor's interest and Lessee's interest in the property as on year 2015. There is a lease condition that on maturity of lease, building will vest with Lessor free of cost. Rent Control Act is applicable to the tenants in the building but not to Lessee.

Solution : (A) Lessor's interest in 2015 is twofold.

* Right to receive lease rent income for 25 years more.

* Right to receive house rent income after 25 years. (Due to Rent Act, house tenants cannot be evicted).

(i) Capitalised value of lease rent income at 8% for 25 years period.

$$\text{Y.P.} = \frac{1 - \frac{1}{(1+R)^n}}{R} = \frac{1 - \frac{1}{(1+0.08)^{25}}}{0.08} = 10.675$$

Value in 2015 = 4,000 x 10.675 = Rs.42,700/- … … (a-1)

(ii) Capitalised value of house rent income after 25 years at 8% in perpetuity.

$$= 50{,}000 \times \frac{100}{8} = \text{Rs.}6{,}25{,}000/\text{-}.$$

Present value of this right (Defer value at 7% for 25 years) :

$$\text{Deferment factor} = \frac{1}{(1+R)^n} = \frac{1}{(1+0.07)^{25}} = 0.1842$$

Present value in 2015 = 6,25,000 x 0.1842 = Rs.115,125/- … … (a-2)

(iii) Total value of Lessor's interest : Rs.42,700 + Rs.115,125

= Rs.157,825/- Say Rs.158,000/- … … (a-3)

(B) Lessee's interest in the property is only one. Right to receive house rent for 25 years more. As Lessee would lose rental income after 25 years, we must provide for Redemption of capital invested in house also (Duel rate to be used).

Capitalised net income at 8% and also providing for redemption of capital at 4% for 25 years period, we get value of Lessee's interest :

R = 8 %   r = 4 %   n = 25

$$\text{Y.P.} = \frac{1}{R + S} \qquad S = \frac{r}{(1+r)^n - 1} = \frac{0.04}{(1 + 0.04)^{25} - 1} = 0.024$$

$$\text{Y.P.} = \frac{1}{0.08 + 0.024} = 9.614$$

Value of Lessee's interest = Rs.50,000 x 9.614 = Rs.480,700/-   Say Rs.481,000/-   …… (b)

In this case, value of Lessor's interest is 24.72% and value of Lessee's interest is 75.28% in total value of the property.

6.50 <u>Example-3</u> : In a small town, land was leased for construction of Cinema in 1985. Lease period was 35 years and lease rent for land was fixed at Rs.40,000/Year. Lessee constructed cinema and started running the same himself. Net income from cinema in year 2014/2015 is Rs.3,50,000/Year. Calculate value of the Lessor's interest and also value of the Lessee's interest in the property as on 2015. The lease deed provides that cinema with machinery would vest with Lessor free of cost on maturity of lease i.e. in the year 2020.

<u>Solution</u> : (A) Value of Lessee's interest is only to run cinema and earn income for 5 years more. As this income would cease after 5 years, we must provide for redemption of capital also. Capitalising net income at 12% and allowing for redemption of capital at 4% for 5 years period, we get Value :   R = 0.12 r = 0.04 n = 5

Value of Lessee's interest = 350,000 x 3.27 = Rs.11,44,500/- Say Rs.11,45,000/- … (a)

(B) Value of Lessor's interest is twofold :

* Right to lease rent income for 5 years.

* Right to cinema income after 5 years due to reversion clause.

(i) Right to lease rent income at 8% for 5 years :

40,000 x 3.993 = Rs.159,720/-   …   … (b-1)

(ii) Right to cinema income after 5 years would last for another 25 years. (Future life of cinema building in 2020). Hence capitalizing net income at 12% for 25 years period and allowing for redemption of capital at 4% we get :

Value of Lessor's interest in cinema : = Rs.350,000 x 6.944 = Rs.2430,400/-

Present worth of this capital sum is determined by deferring value at 8% for 5 years period

= 24,30,400 x 0.6806 = Rs.16,54,130/- … (b-2)

(In this, reversionary value of land is ignored due to profit rental for 25 years after 2015).

Total value of Lessor's interest :

Rs.1,59,720 + Rs.16,54,130 = Rs.18,13,850/-.

Say Rs.18,14,000/- … (b-3)

In this case, value of Lessor's interest is 61.30.% and value of Lessee's interest is 38.70.% in total value of the property.

6.60 It is worthwhile to study and compare the result of above 3 examples.

	Value of Lessor's interest in the property	Value of Lessee's interest in the property
Example-1	5.55 %	94.45 %
Example-2	24.72 %	75.28 %
Example-3	61.30 %	38.70 %

It will be seen from the above results that Value of the Lessor's interest and Value of the Lessee's interest in the leasehold property , mainly depends on the terms and conditions of the lease. Person having greater interest as per lease deed provisions, will have higher share in the value of the property and the person having smaller interest under the deed will have lower share in the value of the property.

7.00 Lease Rent fixing for leasehold land is very tricky assignment. Fixing lease rent for the 1st period (Initial period) and fixing lease rent for the 2nd period (renewal period) depends on several factors. Again norms and factors for lease rent fixing for the private sector land owners and public sector land owners also vary greatly.

7.10 In case of privately owned land, lease rent fixing norms are market based . It is more or less based on INVESTMENT THEORY. Hence valuer can fix lease rent based on land value and expected yield rate by the investors in the real estate market. Judgement of Small causes court ,Bombay in case of Sorab Talaty V/s Joseph Michem (Appeal No. 101 of 1949-Vol-2 SOC-P 162) is useful in this regard. This was the first time that the court accepted and endorsed Investment Theory viz. Concept of return on investment in Real Estate. In this case court allowed 1.50 % higher yield rate than yield rate from government security , as fair return on freehold land value to the investors of land. For investment in leasehold land 2.50 % higher return was considered proper. In 2015 , if yield rate of Government security is 8.50 % , than Valuer may fix lease rent up to 11 % (8.50 + 2.50) of the land value today for first period of lease of the land. For fixing lease rent for second period of lease, norms are little different as discussed herein after. However it must be remembered that even for the first time lease rent fixing , if expected yield rate prevalent in the market is lower , say 9 % , than valuer should fix lease rent at 9 % return instead of 11 % upper limit worked out as per court's view in above judgement. That is why it is called lease rent is market based.

7.20 Generally in renewal clause of lease deed, it is provided that in case of renewal of lease for 2nd period , renewal lease rent will be fixed by MUTUAL CONSENT of Lessor and Lessee or mutually agreed rent. Now this mutual consent cannot be totally devoid of prevalent market base or market trend. It is a case of transaction(Rent fixation) in closed market and not in an open market like first time leasing of the property. Though Lessor is bound to renew lease and lessee is in legal possession of property , both cannot ignore prevalent market at the time of renewal and none of the two can say that rent be fixed in his favour because his interest is greater in lease property.

Following additional points are required to be considered by the valuer while fixing renewal lease rent for the 2nd period while applying investment theory of lease rent fixation.

(i) The lessor is not free to lease property to the third party but is bound to renew lease with the sitting lessee only .

(ii) In that way it is a case of closed market for rent fixation. There are no competing tenants bidding for lease rent in the market as is the case for first time leasing of the property. Closed market or lack of competing tenants means low rental.

(iii) The land offered for lease renewal is not an open virgin land as is the case for first time lease but is encumbered with the structure erected by the lessee. Obviously land value under investment theory has to be discounted for this reason.

(iv) Even otherwise value of land to the lessor on date of renewal is less because of further renewal period. Its present worth is only deferred value of land and not value as if freehold. Hence yield has to be worked out on deferred value of land which is its market worth on date of renewal of lease.

(v) The prevalent yield rate under investment theory may work out to say 11 % , market trend or investors expectation in market is say 9 % , yet for renewal lease rent lower yield rate of say 7 % has to be considered because of closed market and bounden duty of lessor for renewal.

7.30 However if leased land is owned by a public body like Port Authority , Municipal Corporation ,Government Industrial Corporation , State Government or Central Government , the criteria of lease rent fixation are quite different.

In such a case Judgement of Supreme Court in case of Jamshed Wadia V/S Bombay Port Trust (Civil Appeal 5559 of 2001) decided by Supreme Court on 13-1-2004 is helpful. This was an interesting case on fixation of lease rent for the public body , for the renewal period of lease. The leased land was owned by Central Government controlled Public Body, viz. Bombay Port Trust.

In this case Supreme Court held that : "The Bombay Port Trust is instrumentality of State. It cannot afford to act with arbitrariness or capriciousness. All its action must be for public good, achieving the objects for which it exists, and accompanied by reason and not whim or caprice."

Earlier in this case Bombay HC had held that : " BPT was entitled to protect itself against erosion in the rental as a result of inflationary trend, but BPT could not afford to behave like a private land lord indulging into rack renting by co-relating the rates of rent with market rates. "

Approving this view S.C. held : " As the land lords they have the liberty of revising rates of rent so as to compensate themselves against loss caused by inflationary tendencies. However, the State cannot be seen to be indulging in rack renting, profiteering and indulging in whimsical or unreasonable evictions or bargaining. "

Court also held : <u>“ Accepting current market rates of Real Estate and working out a return on such rates by reference to the market trends, would tantamount to indulging into profiteering. ”</u>

Under compromise proposal, in this case, BPT had proposed 15% return on land value for non residential user of land and 12% return on land value for residential user land. Bombay H.C. directed that these rates be fixed at 6% for commercial and 4% for the residential user land.

Supreme Court finally held : “ The rates of 10% and 8% are very fair and reasonable and Bombay Port Trust ought to accept the same. ”

Thus in market if investors and private landlords expect return of 12% on value of residential user land, landlords like BPT are permitted only 8% yield rate on land value while revising lease rent for the renewal period.

7.40 It may not be out of place to mention here that state governments normally adopt 6% yield rate on land value while fixing lease rent for the first time. However renewal of lease rent has always remained a point of controversy.

7.50 Recent press news dated 28th April 2015 says that Trust Board of same Bombay Port Trust have sanctioned increase in lease rent of their leasehold properties, by fixing renewal of lease rent at 6% of Ready Reckoner land rates (Stamp duty Rates). Even though this yield rate of 6% is less than 8% approved by S.C., 33 lessees have filed writ petition in Bombay H.C. objecting to increase in Lease rent. One of these petitioner is same Jamshed Wadia of 2004 S.C. Case. Let us hope some new thinking develops on this Lease rent fixation.

7.60 Valuers may be asked by clients to Advice on fair lease rent of Privately owned land or Government owned land . Valuation work could be for fixation of lease rent for the 1 st period or for lease rent fixation for renewal period.

Following examples will explain how to estimate rent in different situations.

8.00 <u>Example – 4</u> : New Delhi Municipal Corporation decided to lease 4000 SM. Plot for residential user for 60 years period with effect from 1-6-2015. Fix annual lease rent for land if prevalent land rate in locality is Rs. 30,000/SQMT and no initial premium is charged to the lessee.

Solution : Land value : 4000 SM @ Rs. 30,000/SM = Rs. 1200,00,000

Lease Rent at 6% yield = Rs. 72,00,000 / Year.

8.10 Example – 5 : Bombay Port Trust had leased 1000 SM plot in year 1916 for 99 years period at lease rent of Rs. 120 / Year. There is a renewal clause for further 30 year period. Fix lease rent for renewal period of 30 years from year 2015 , if land rate in 2015 is Rs. 15000 / SQMT.

Solution : Land value as if freehold in 2015 :

= Rs. 1000 @ 15000 / SM

= Rs. 150,00,000

Lease rent at 8% = Rs. 12,00,000 / Year.

8.20 Example – 6 : A Petrol Company is offered a plot, along a Highway, close to a metropolitan town. Plot area is 2000 Sq.Mts. and lease period is 30 years . Prevalent Land rate for N.A. land in the vicinity is about Rs. 5000 / Sq.Mt. Advice on lease rent for the plot.

Solution : Value of land = 2000 x 5000 = Rs. 100,00,000

Lease rent at 6 % = 100,00,000 x 0.06 = Rs.6,00,000 / Year.

8.30 Sometimes valuer comes across unusual situation . An Interesting case of Premature Termination of lease and instructions of Lessor for fixing lease rent of privately owned leased land is worth study.

Example – 7 : Privately owned land having area of 11,230 SQMTS was leased on 19-2-1965 for industrial use for a period of 98 years with a right to sublease. Lease Rent was fixed at Rs. 40,361/year on the basis of 7.5% yield on land rate in 1965. Lessee constructed industrial building on plot and subleased property to society of Gala purchasers in 1992. There was breach of covenant of Head lease on account of non payment of lease rent for a period on 6 months. Lease rent was not paid by the lessee nor by sublessee to the Lessors . Lessors therefore Terminated Lease premature in 1976 on grounds of breach of lease covenant. Lessee did not contest the case but Sublessee society requested for renewal or fresh lease with new terms. Advice on new lease rent if prevalent land rate in 1976 was Rs. 190/SM and sublessee society is willing to pay Rs. 6 Lacs as initial premium.

Solution : Total Value of land in 1976 : = 11,230 × 190 = Rs. 21,33,700

Less initial premium. = Rs 6,00,000
Net Amount = Rs. 15,33,700.

Bank rate in 1976 was 9% and interest on fixed deposit in Bank was also 9% . Average yield rate on investment in Govt. security was 6 .00 %. Investment in leasehold land is less secured than investment in Govt security. Hence at least 2.50 % extra yield would be expected above yield rate on G – Sec. i.e. 8.50 % (6.00 + 2.50).

Lease rent at 8.50 % on Balance amount of Rs. 15,33,700

= Rs. 130,364 / year

Say Rs. 1,30,000 / year.

It will be seen that because of mistake of Lessee, for lease rent payment default, sublessee society had to pay , Lease rent of Rs.130,000 / year instead of agreed lease rent of Rs.40,361/year , plus damages of Rs. 6 Lacs as initial premium.

This example is an Eye opener. Once lessor terminates lease for breach of covenant, lessor can enter the property and take possession. Industrial Galas erected on land would become property of lessor. Once lease is terminated and if sublessee society does not get fresh lease from lessors, society is liable to pay damages in form of Mesne profits for continued illegal possession of the property till new lease agreement is made.

It may be worthwhile to note that in this case, initially sublessee society filed suit claiming protection against eviction under provisions of Rent Control Act. But the case was dismissed by small causes court of Bombay by stating that Rent Act is not applicable to this case. Finally sublesee society had to agree to pay damages and new lease rent.

8.31 Very recently similar case of Premature Termination of lease was reported in newspaper dated 9th July 2015. It was not a private lease but Municipal Lease. Lessors were Estate department of MCGM . Lessees were Kamala Raheja Foundation. Lease period was for 30 years from 1992 . Annual lease rent was Rs. 3.65 Lacs. MCGM have threatened to terminate lease premature in 2015 because lessees have violated certain terms of the lease agreement and breach of subsequent undertaking by the lessees. Now Lessors have asked Lessees to pay penalty of 4.75 crore for regularizing breach of covenant. MCGM may also ask lessee to pay new lease rent and make new lease agreement just like private lease example cited above.

8.40 Example – 8 : Lessee took on lease strip of land admeasuring 10750 SQMT (River Side rear land) next adjoining to his freehold land (Road side front land) having

Area of 15500 S.M. Lease agreement was dated 25-3-1972. Lease terms were as under.

(i) 1st period of lease 40 year wef 24-3-1972 with lease rent of Rs. 1000/year.

(ii) lease to be renewed for 2 more periods of 30 years and 29 years at Mutually agreed lease rent.

(iii) on maturity of lease in 2071 i.e. after 99 year ,vacant land will revert back to lessor.

Office building was built on front free hold land using FSI of rear leasehold land also. Advice on fresh lease rent for 2nd period i.e. from year 2012, if prevalent land rate in year 2012 was Rs. 23400 / SQMT.

Solution :

Total land value in 2012 = 10750 SM at Rs. 23400 / SM = Rs. 25,15,50,000

The leased land was in the rear and was not having any access. Hence its value will be 25%.

= ¼ × 25,15,50,000

OR Rs. 628,87,500

Lessor is bound for two more Renewal of 30 +29 years also. Hence its present value in 2012 has to be deferred for 59 years at 6%.

= 628,87,550 × 0.0321

= Rs. 20,18,688

Revised lease rent for 2nd period of 30 years at 6% of value as in 2012,

= 6/100 × 20,18,688

= Rs. 121,121 / year

As stated before lessor cannot claim full market rental as this is the case of closed market. The revised rental value has to be something less than prevalent market trend in open market.

Allowing 20% rebate for renewal compulsion in closed market,

Revised lease rent in year 2012 :

= 0.80 × 121,121 = Rs. 96896 / years

Say Rs. 96,000 / year

Original rental of Rs. 1000 / year now becomes Rs. 96,000 / year as it is market based.

There are two issues which has to be thoroughly understood from this example.

First issue is about covenant that “ Renewal rent shall be mutually Agreed Rent. ”

Now lessee cannot say that you are bound to renew lease and hence I will pay low rent say Rs.2000 / year only in place of Rs. 1000 / year. At the same time , Lessor cannot ask lessee to pay fancy rent of Rs. 56 Lacs per year based on 6.28 Cr. land value in year 2012. Even rent of Rs. 121000 / year also cannot be demanded because lessee has invested huge sum in building construction. Mutual agreement or Mutual consent implies market base. It cannot be devoid of Market trend. New or revised lease rent has to be little less than prevalent market rental on renewal date.

Second issue to be learnt in this example is the fact that lessee has kept rear leased land vacant & used its FSI on his free hold land in the front. If lessee himself refuses for renewal, lessor cannot do anything. It will create a legal stalemate. Lessee will return back open land to lessor and will pay no rent .On rear landlocked land no development will be allowed even if lessor obtains access from nearby land. This is because its FSI is already utilized by the lessee on the front plot. Lessor in such a case will have only recourse to claim damages from defaulting lessee or sell land to said cheater Lessee at throw away price.

8.50 Many a times valuer comes across assignment where in important data is incomplete or missing. Valuer may also have to face a situation where in possession of land is given and land is also developed but transfer of property has not taken place as required under Transfer of Property Act and terms of transfer is also not known . Valuer in such a case has to do function of a judge and make appropriate assumption so that the property could be valued in spite of irregularity. Following example explains the situation.

Example – 9 : Plot A & Plot B are amalgamated and its owner (Lessor) has offered plots for Bank loan security. Plot A is free hold & Plot B is lease hold with Lease Rent of Rs. 60,000 / year for 30 years period. Bungalow costing Rs. 40 Lacs is built on Two plots by lessee. Plot areas are 200 SQMT each and present free hold land rate in locality is Rs. 5000 / SM . Advice bank on market value of lessors interest in the property.

Solution : As lessee has constructed building on 2 plots, without lessees right on plot ' A ', it has to be assumed that plot- A is also on lease. Total probable rental income receivable from the lessee for plots A and B ,would be 60,000 + 60,000 = Rs.120,000 / year.

(a) Capitalising receivable Lease Rent income at 8% for 30 year Period and allowing for redemption of capital at 4%.

We get , Value of lessor's interest in Land :

= 120,000 × 10.222 = Rs. 12,26,640 ……… (a)

(b) Present value of land on maturity at 7% reversion for 30 year period :

= 400 × 5000 × 0.1314 = Rs. 262,800 ……… (b)

(c) Present value of building by considering reversion at 7% for 30 years.

= 40,00,000 × 0.1314 = Rs. 525,600 ……….. (c)

Total value of lessor's interest in the property :

= 12,26,640 + 262,800 + 525,600

= Rs. 20,15,040

Say 20,15,000/- …………. (d)

It will be seen that plots with building if freehold would have value of Rs. 60 Lacs but due to lease of 30 years, lessors interest has value of only Rs. 20.15 Lacs.

Secondly , valuer has to make appropriate assumptions ,in case of defective or incomplete data so that things can be set right for valuation. In present case there is no lease for plot A yet lessee has built building on both plots. This obviously means that lessor has no objection and deemed consent is available for lease of plot –A and also for construction of building on combined plots..

8.60 Example – 10 : Owners shop had fully gone into road widening in 2010. He was offered alternate shop premises (Area 200 SFT) in Shivshakti Shopping Centre in Town. Premises was given on Lease for 30 years with Lease rent of Rs. 240/year. In case if shop is sold, Lessor will ask for transfer charges of Rs. 20,000/-. Prevalent shop rental in the locality is Rs. 50/SQFT/Month. Value the Lessees Right in shop in year 2015.

Solution : As in 2015 unexpired period of Lease is 25 years after which shop will belong to Lessor. Hence value has to be estimated by Rental Method.

Probable Market Rent = 200 × 50 × 12 = Rs. 120,000 / year

Capitalising yield at 9% and allowing for redemption of Capital at 4%, for future 25 year, we get Value of Lessee's interest in shop :

= 120,000 × 9.614 = Rs. 11,53,680

Less Transfer Charges = Rs. 20,000

Net Value of Lessee = Rs. 11,33,680

Say Rs. 11,34,000/-

There is every likely hood that local authority (Lessors) may not take over possession of shop after 25 years but may enhance lease rent of shop or offer shop on ownership basis at concessional rate. (Below Market Rate).

8.70 Example – 11 : Shop No. 1234 having 240 SQFT area is situated in prominent Cloth Market at Surat . Market Rental for the shop is Rs. 500,000/year and prevalent ownership rate for the shop is Rs. 50,000/SQFT. Cloth Market is on Leasehold land from Surat Municipality with 60 years Lease wef 18-4-1968. Value shop in 2015.

Solution : Unexpired period of Lease is only 13 years in 2015. Hence safest way is to Capitalise Market Rental at 8% for future 13 years period and allow for redemption of capital at 4%.

Value of Shop = 500,000 × 7.136

= Rs. 35,68,000/- …………….. (a)

However more practical view would be to adopt prevalent market rate in cloth market according to which.

Value of Shop = 240 × 50,000

= Rs. 120,00,000/-

Allow 20% rebate for risk of lease rent increase after 13 years.

Present Value = 0.80 × 120,00,000 = Rs. 96,00,000/- ………. (b)

It should be understood that normally quoted market rates always takes into account risk of lease termination after 13 years period. Yet there is nothing wrong to allow 20% rebate for risk. There will be hundreds of shops in the cloth market. There is every likely hood that Surat municipality may not fix exorbitant lease rent after 13 years. Supreme Court's decision in BPT case is a precedent for lease rent fixation by public body who cannot do exploitation & cannot work against Public Interest.

8.80 Example – 12 : In a Layout of 44 same size plots , colony land is leased to society (44 plot owners are members) in year 2010 for 99 years period at Lease rent of Rs. 5000/Month. Rs. 2 crore non refundable deposit is also taken. Lease is renewable for further period of 99 years at mutually agreed rent with lessee society. In Plot No. 1 office cum residence with 2000 SQFT Built up area is built by the member. FSI is fully utilised. Advice on market value of Lessee's Interest in Plot No. 1 as on 31-3-2015.

Solution : In this case, Lessees interest has to be estimated by formula :

Value of Lessees Interest = Value as if Freehold – Value of Lessors interest.

If prevent ownership rate for residence is Rs. 9000/SQFT.

Value as if free hold = 2000 × 9000

= Rs. 180,00,000/- ……… (a)

Lease Rent for 44 plots of the colony

$$= 5000 \times 12 + \frac{8}{100} \times 200,00,000$$

= Rs. 16,60,000

Prorate Rent for plot 1 = 1/44 × 16,60,000

= Rs. 37,727/year.

Lessors Interest at 7% . $= 37{,}727 \times \frac{100}{7}$

$= $ Rs. 538,957/- Say Rs. 539,000/- ………… (b)

Value of Lessee's Interest : = 180,00,000 – 539,000

= Rs. 174,61,000/- …………. (c)

8.90 Example – 13 : Lessee has taken 3000 SQMT plot on Lease in 2010 for 99 years period. Lease rent of Rs. 180,000/year is payable. Lease is renewable for further period of 99 years at mutually agreed rent. Lessee subleased 1000 SQMT land in 2012 for 96 years period at Rs. 120,000/year lease rent. Lessee erected factory building on balance plot of 2000 S.M. in 2015 at cost of Rs. 1.50 Crores. Advice on value of Lessee interest in property in year 2015.

Solution : Lessees interest in the property is twofold.

(a) Income from subleased plot and (b) Occupancy Rights in Balance land & factory.

(a) Lessee's right in subleased plot = Profit Rent.

i.e. $120{,}000 - \frac{180000}{3}$ = Rs. 60000/year

Capitalizing net yield at 8% in perpetuity.

Value of Lessee's Right in sublease plot of 1000 S.M. :

$= 60000 \times \frac{100}{8}$

= Rs. 750,000/- ……….. (a)

(b) Assuming land rate for freehold land in locality at Rs. 1000/SM,

Land value of 2000 SM at Rs. 1000/SM = Rs. 20,00,000.

Lessors interest in land value of 2000 SM portion of land :

$= \frac{2}{3} \times 180{,}000 \times \frac{100}{8}$

= Rs. 15,00,000/-

Lessee's interest in 2000 SM land = 20,00,000 – 15,00,000 = Rs. 500,000 /- (b)

(c) Value of New Factory same as COST = 150,00,000/- ………… (c)

Value of Lessee's interest in entire Leasehold property

= a + b + c

= 7,50,000 + 5,00,000 + 1,50,00,000

= Rs. 162,50,000/- …………… (d)

9.00 Valuer also comes across assignment where government policy about premium charges or lease rent are not known or not finalized and yet the leased property is required to be valued. Valuer, in such a case, has to first sit like a judge or a policy maker and consider facts and circumstances of the case and decide what could be the fair and equitable policy. Valuer can thereafter make appropriate assumptions to work out the value. Following example explains the situation.

Example – 14 : Two Godown buildings (10500 SFT + 12800 SFT) are existing since 1978 on leasehold plot (Area 4840 SQYD) at Kochi Port. Lease from Kochi Port Authority was for 30 years from 7-10-1978. There was no renewal clause. Lease Rent is Rs. 81,900 / year. Prevalent Market Rent for the godown was Rs. 8 / SFT / Month in 2008 . Advice on value of property (Lessee's right) as on 31-3-2008.

Solution : In this case , there are two possibility for estimating value of Lessees interest in the property.

Possibility – 1 : Port Authority will not renew lease in October 2008 but would take back possession of land and would perhaps pay depreciated cost of Godowns .

Possibility – 2 : Port Authority will renew lease for further period of 30 years at new lease rent of Rs. 527,000 / year.

Valuation : (A) : Lessee can earn rent for 7 months

= 23300 × 8 × 7 = 13,04,800

Less Lease Rent of Rs. 81900 = 81,900

Net income Rs. 12,22,900

Prospective buyer may be willing to pay 40% of this 7 months income.

Value of Lessees right in rental income = 0.4 x 12,22,900

= Rs.489,160 ……… (a - 1)

Lessee is entitled to Depreciated Cost of Two Godowns.

(i) Replacement Cost = 23300 × 1200

= Rs. 279,60,000

(ii) Depreciation = $\frac{30}{50}$ × 279,60,000 = Rs. 167,76,000

(iii) Net Depreciated Value = 279,60,000 – 167,76,000

= Rs. 111,84,000 ……. (a - 2)

(iv) Value of Lessee's right in the Property = a - 1 + a - 2

= Rs. 4,89,160 + Rs. 111,84,000

= Rs. 116,73,160

Say Rs. 116,73,000/- ……. (a – 3)

Valuation (B) : Lessee can get rental for further 30 years period by maintaining godowns.

Gross Annual Rent Income = 23300 × 8 × 12

= Rs. 22,36,800

Less Probable revised Lease Rent = Rs. 5,27,000

Net yield = Rs 17,09,800

Capitalising net yield at 8% for 30 years and allowing for redemption of capital at 4%.

We get value of lessee's interest in property in 2008 = 17,09,800 × 10.222

= Rs. 174,77,575

Say Rs 175,00,000/- ……….(b)

Here value of Lessees Right differs by 50 %. Valuer must in such case should select most probable option or give both valuations.

In present case Value of Rs. 1.75 Crores can safely be recommended because in year 2008 there was every likelihood of Kochi Port authority giving renewal lease for 30 years further period by charging higher revised lease rent.

10.00 The above examples are for Building leases. In occupational lease where land and building both belong to Lessor and both are leased together for certain period also have valuation problems about value of Lessors interest in the property. Normally in occupational leases only lessors have marketable interest. Lessee do have right of occupation but this right in most of the cases is not transferable as is the case with Lessees of building lease. In occupational leases we sometimes come across controversy about proper market value of Lessor's interest in the property. This is because Rental value of the premises go on changing in the Real Estate Market, even during lease period, depending upon demand and supply and prices of Real Estate. However once premises are leased out, benefit of rental increase in subsequent year, is not available to Lessor. Similarly benefit of reduction, if any, in rental rate in the market, in subsequent year, is not available to Lessee, as he is bound by agreed rental value during lease period. This variation sometimes results in situation where market value of leased flat is either higher or lower than its real worth as vacant premises.

10.10 Example – 15 : An office block (Area 15000 SQFT) in Delhi Special Economic zone (Sez) is leased for 5 years period at Lease rent of Rs. 30/SQFT/Month. Advice on market value of office Block in year 2015 after lease.

Solution : In Sez area property cannot be sold on ownership basis. Again Lessee company has to be export oriented only. Hence market is limited and investment is very risky. Value has to be worked out by Income approach.

Gross Annual Receivable Lease Rent : $= 15000 \times 30 \times 12$ = Rs. 54,00,000/year

$$\text{Value of property} = 54{,}00{,}000 \times \frac{100}{12}$$

= Rs. 4,50,00,000/-

Even though Lease in for 5 years period, rental income is capitalized in perpetuity assuming that at least same rent will be receivable after 5 years.

10.20 Example – 16 : Shop 24 in Rahul Raj Cloth Market at Surat is leased for 9 years in 2015 at lease rent of Rs. 6,60,000/year. Rent will be increased at 15% after every 3 years period. Lessor bears tax of Rs. 10,000/year. Present value of shop if vacant is Rs. 73,00,000/-. Advice on value of Lessor's interest in the shop, in 2015, after shop premises are leased.

Solution : This is the case of Occupational lease. Present Value of Lessors interest has to be estimated in 4 stages (4 periods of lease with different rents) as under.

(i) Value of 1st period of 3 years in 2015 :

Net Rent (660,000 – 10,000) is capitalised at 7% for 3 years

$= 650{,}000 \times 2.624$

= Rs. 17,05,600 .... (a)

(ii) Value for 2nd period in 2018 :

Net Rent = $(1.15 \times 660{,}000) – 10{,}000$ = Rs. 749,000/year

Value for 3 years income in 2018 : $= 749000 \times 2.624$ = Rs. 19,65,376

Deferring Value at 6% for 3 years period we get Present value in 2015 :

$= 19{,}65{,}376 \times 0.8396$

= Rs. 16,50,130 ……………… (b)

(iii) Value for 3rd period in 2021 :

Net Rent = $(1.15 \times 759{,}000) – 10{,}000$ = Rs. 8,62,850/year

Value for 3 year income 7% in 2021 : $= 862{,}850 \times 2.624$

= Rs. 22,64,118/-

Deferring value at 6% for 6 years period, we get Present value in 2015 :

$= 22{,}64{,}118 \times 0.7050$

= Rs. 15,96,203 ……………. (c)

(iv) Reversionary Rights of shop after 9 years period.

Reversionary value at 6% for 9 years period we get Present value in 2015 :

$= 73{,}00{,}000 \times 0.5919$

= Rs. 43,20,870 ………………. (d)

Present value of shop 24 to the Lessor/Owner as in 2015 after leasing for 9 years.

= 17,05,600 + 16,50,130 + 15,96,203 + 43,20,870

= Rs. 92,72,803

Say Rs. 92,73,000/-

It will be seen that shop with vacant possession is worth only Rs. 73 Lacs but after lease contract, its market worth is Rs. 92.73 Lacs. This means that market rental in cloth market is higher than normal expectation of investor in real estate market. In this example it is seen that Lease rent is fixed at 9.04% where as market expectation is only 7%.

10.30 Example-17 : An investor purchased 5 bed rooms flat having an area of about 2500 Sq.ft. area, in the year 2013, in Mumbai, at the cost of Rs.5 Crore. Owner leased the flat to multinational company for a lease rent of Rs.120,000/Month for 5 years period. Rs.1 crore interest free deposit was also taken. Society maintenance charges were Rs.65,000/3 months. Calculate fair market value of flat(Value of Lessors interest) as on 2015, if ruling rate of flat in locality is Rs.30,000/Sq.ft. Expected rental yield on investment in flat, in the year 2015 is 5% and market yield on other sound investment is 8%.

Solution : Normally value of flat as vacant would be :

2500 x 30,000 = Rs.7,50,00,000/- in year 2015.

However flat is leased for 5 years period and hence vacant possession is not possible in 2015 for another 3 years i.e. upto year 2018.

Value of Lessor's right in flat in the year 2015 is twofold.

* Rental income for further 3 years period.

* Right to receive back flat after 3 years.

(a) Capitalised value of rental income is as under :

Gross Annual Rent = Rs.120,000 x 12		= Rs.14,40,000
Add : Interest at 8% on security deposit of 1 Crore		= Rs. 8,00,000
	Total Annual Income	= Rs.22,40,000
Less :	Society maintenance : Rs.65,000 x 4	= Rs. 2,60,000
	Net Annual Yield	= Rs.19,80,000

Capitalising net receivable yield at 5% for 3 years period we get value of

Lessor's interest in 2015 : 19,80,000 x 2.723 = Rs.53,91,540/- ……… (a)

(b) Lessor also have right of reversion in year 2018. Value of reversion of flat is worked out by deferring present value as if vacant at 8% for 3 years period.

Present worth of flat to Lessor for reversion of flat :-

Rs.7,50,00,000 x 0.7938 = Rs.5,95,35,000/- … …… (b)

Total value of flat (Value of Lessor's interest in year 2015) :

= Rs.53,91,540 + Rs.5,95,35,000 = Rs.6,49,26,540/-

Say Rs.6.49,00,000 …..… (c)

10.31 Though market value of flat with vacant possession is Rs.7.50 Crore, its sale value in 2015, in open market, is only 6.49 Crore. This is because expected rental yield for such a flat has increased to about Rs.312,500/Month in 2015 at 5% yield vis-à-vis Rs.120,000/Month fixed two years back in 2013. Expected yield rate in 2013 was hardly 3% on value of the flat, due to less demand for rental flat in the market in 2013.

10.32 Normally yield rate on investment in Real Estate should be higher than yield rate on G-sec as approved by the court while endorsing Investment Theory. But in practice this rate is found lower than G-Sec yield. This apparent paradox in investment market is called "Reverse Yield Gap" This low yield rate is due to Capital Appreciation prospects during holding lease period

10.33 In above example and several other cases of properties given on Leave and Licence basis, prevalent yield rate in the market ranges between 4% to 6 % on the Investment. Prima facie this may appear absurd. When yield on G-sec is 8.50 % and Interest rate on 3 years F.D. in Nationalised Bank is 8.25% why would investor be satisfied with only 5 % return on the investment ? Answer to this query is that Leave and licence contract is under Easement Act and Rent Act is not applicable to such properties. Hence owner of premises can evict the occupant on expiry of the licensed period and can licence the premises at increased rental OR can sell the flat to take advantage of capital appreciation in the premises.

If this appreciation is considered, intrinsic yield or actual rate of return would be 18 % to 24 % or even more . This will be clear if we analyse figures in above example.

10.34 In above example , on 5 Cr. Investment owner got net return of 19.80 Lacs. i.e. only 3.96 % yield on investment. However during 2 years licensed period price of flat appreciated by 2.50 Crores . If owner was able to sell flat with vacant possession in 2015, his additional return per year will be Rs. 1.25 Cr. On investment of Rs. 5 Cr. this extra return works out to 25 % / year . Which means that investor’s actual return is 4 % +25 % = 29 %.

10.40 A very interesting case of city of London in respect of Occupational Lease and changes in the Real Estate Rental Market is worth study . A landlord (Lessor) wanted to let out his commercial premises when rentals were considerably rising. He offered the large office premises in his building to a prospective lessee tenant (who was fully aware of the market that the rentals are going up) at a slightly lower rent than prevalent rental . Long lease period was agreed by both the parties. However lessor put one special condition that in the event of lessee vacating the premises before agreed term (Lease period) , he will pay damages/compensation to the landlord. The tenant agreed to this condition because according to his calculations the rentals were to go up further and not fall down .

But, in reality it so happened that in a short span of one year rentals went down by 50% i.e. the next door identical premises were available at 50% of rent paid by him. The lessee tenant could not vacate the premises as the benefit of 50% rent was less than the damages required to be paid to landlord (Lessor) in the event of premature vacating of the premises as per the terms of lease contract. Thus sometimes situation arises in OCCUPATIONAL LEASES i.e. rented/leased properties when value to the lessor, value to the lessee and value to the market with vacant possession are all different. Rights held by each will determine the value of the premises to him.

10.41 Similar large office area Occupational lease termination case has happened in India also. Sahara Group entered into lease agreement in 2012 for 9 years period. Office area under lease was 400,000 Sq.Ft. on 5 floors in “Parinee Crescenzo Tower” in B.K. Complex Bandra-Mumbai. Lease rent of Rs. 90 Crores / year was agreed for this biggest lease deal of India. Sahara did not pay rent in 2014 and offered surrender of lease premature in July 2015. Lessors forfeited the deposit. It is not known what damages the lessors would claim for premature termination of lease. However in this case surrender was not because of lower rent in nearby area but for cost cutting and to save their Chairman Subrata Roy who is in Jail.

10.50 Valuation of the residential properties given on Leave and License are very similar to the valuation of the properties given under occupational lease. Only difference is that Occupational lease is controlled by the provisions of Transfer of Property Act where as premises given on Leave and License are governed by the provisions of Easement Act.

10.60 Valuer is sometimes called upon to estimate Standard rent of the premises. If STANDARD RENT of the premises is required to be worked out, the valuer can very well work out the rent on the basis of INVESTMENT THEORY by allowing prescribed yield rate on the investment in land and building. This has also to be worked out keeping in view the provisions of relevant Rent Control Act . However if MESNE PROFITS (Market Rent) for the premises are required to be worked out, for awarding damages to the Lessor for illegal occupation of the premises occupant/Lessee, the valuer has to apply MARKET APPROACH i.e. RENT COMPARISION METHOD of rent fixation. Mesne profits are to be fixed as per provisions of Civil Procedure Code. Market rent worked out on Investment Theory is not accepted by the court in such cases but court insists for details of comparable rents in the locality (Rent Comparision Method) at the relevant period of time. Thus valuer must be very careful in selecting appropriate methods for working out rent of the property.

11.00 It will be seen from examples of leased properties, licensed properties and rent controlled properties, how important it is for a valuer to select proper rate of capitalization to arrive at the fair market value of the property.

We may not generalize but broadly speaking we can say that :

For Building Leased out property (Land lease) 6 % to 7 % yield rate may be enough .

For Occupational lease or licensed properties 4 % to 5 % yield rate may be appropriate.

For rent controlled properties, 9 % yield rate may be considered proper today.

11.10 Rate of return expected by multinational foreign investors is again quite different. None of the above yield rate will fit in their expectation. They invest in Real Estate Projects in India costing multi million dollars .They require valuers advice on rate of return on such projects and in such case valuer has to do project analysis and work out the yield rate by Internal Rate of Return (IRR) method OR by considering DCF technique.

11.20 Thus Real Estate Market is flooded with several types of yield rates . Moreover prevalent yield rates in the different city may also be different . Valuer should therefore first find out from the Real Estate Market , the ruling yield rate for different type of properties. As valuers we must understand the great importance of selecting correct rate of capitalization. Even 1 % variation in rate of capitalization may sway the value of the property by 10 % to 12%.

The Valuer should decide the rate only after proper market inquiry .Selection of the most appropriate rate of capitalization should be based on the type of the property and rate prevalent in the market for the similar property at the relevant period of time.

12.00 If you are confused about proper rate of capitalization to be adopted for leased or tenanted property, please do not panic. Well known London based Valuer Mr. Nick French was also confused about uncertainty of yield rate prevalent in the market. He was unable to select proper rate of capitalization due to these uncertainties. He suggested statistical concept of probabilities for selecting precise rate and for solving the valuation problem.

Hence, without much worry you just remember famous words of this great professor Nick French who said : " NORMAL UNCERTAINTY IS UNIVERSAL AND UNSURPRISING FACT OF THE PROPERTY VALUATION"

16-7-2015 MUMBAI

* For Seminar to be held at Gurgaon on 16-8-2015 / 17-8-2015.