THE UNIVERSITY OF QUEENSLAND
AUSTRALIA

FINM3406
Real Estate Finance

Lecture 2
Real Estate Ownership Structures – Pt 1

Outline

- Doctrine of tenure and estates:
  - Historical Perspective
  - Freehold - leasehold - licence
  - Native title
- Direct Ownership & Indirect Ownership
- Corporate Real Estate & Investment Real Estate
- Risk Management

DOCTRINE OF TENURE AND ESTATES

Property Law – Historical perspective

- On 26 January 1788 at Sydney Cove, Captain Arthur Phillip R.N. formally took possession of Australia as a settled and occupied colony, thus commencing the settlement of Australia and the introduction of British legal system replacing any indigenous land rights and system of laws.
- Capt. Phillip became governor of New South Wales, (NSW) (which at that time included Queensland and Victoria) and established a settlement.

Property Law – Historical perspective

- Ownership and administration of Land was inherited from English Law. Lord Watson in *Cooper v. Stuart* (1889) clearly states the point

"In so far as it is reasonably applicable to a circumstance of a colony, the law of England must prevail until it is abrogated or modified, either by ordinance or statute ... There was no land law or tenure existing in the colony at the time of annexation to the Crown and ... as soon as the colonial land became the subject of government settlement and commerce, all transactions in relation to it were governed by English law in so far as the law could be justly and conveniently applied to them."

Property Law – Historical perspective

- Under English law, following the Norman invasion of 1066, all property was vested in the Crown.

- Under the feudal system all lend was held from Crown various forms of service were required of the lords who occupied the land these included military, spiritual and socage (payment) and system of Subinfeudation.

- The *Statute of Quia Emptores* 1290 ended Subinfeudation as land owners were able to alienate by substitute without consent of the overlord, thus forming the basis upon which all estates in land are based.

Property Law – Historical perspective

- The Statute of Tenures 1660 converted these various tenures to a much more limited number of which socage or free tenure was the predominant. The Statue of Tenures was repealed and simplified in 1969.
- Land is granted in fee simple is held in perpetuity from the crown without any annual payment due to the crown subject to reservations held by the crown (eg minerals and a right to take back possession of the land under a limited set of circumstances)
- The Colony of New South Wales included what is now Queensland until 6 June 1859 when Queensland became a separate Colony.

Property Law – Historical perspective

- *Constitution Act 1867* (Qld) - all legislative powers within the colony were vested in the Crown in the right of Queensland which was empowered through the legislative assembly to **make laws for the peace welfare and good governance of the colony** (provided not inconsistent with British laws).
- The Governor, on behalf of the Crown, was empowered to grant occupation of crown waste lands. The first meeting of Qld parliament passed the *Alienation of Crown Lands Act 1860* which gave the Governor the right to grant title in fee simple or otherwise of crown waste land.
- The power to grant "unallocated State land" is now with the Governor-in-Council by virtue of s.14 *Land Act 1994* (Qld).

Property Law – Historical perspective

- On 1 January 1901 the Colonies of Australia formed a federation (by the passing simultaneous legislation in each Colony and in the British parliament). The Commonwealth of Australia was established, and the Colonies became States.
- The States retained the right to make laws for the peace welfare and good governance of the State, subject to any inconsistency with express powers given to Commonwealth in the Australian Constitution. **The States did not give up the power to grant land and make laws about property**.
- With commencement of the *Australia Acts* on 3 March 1986 Australia became fully independent of the British parliament and its courts.

Doctrine of Tenure, Estates & Waste

- **Doctrine of Tenure** (spatial)

  All land is held by way of grant from the Crown (or in modern language from the State)
- **Doctrine of Estates** (temporal)

  All land tenure gives the owner the right of possession for specific duration (an estate can be a future interest – ie vested vs contingent)
  - Freehold – uncertain duration
    - Fee simple (akin to absolute ownership)
    - Fee tail (historical – inheritance limited to certain descendants)
    - Life Estate (granted for duration of a person's life – remainder/reversion)
  - Leasehold – certain duration
- **Doctrine of Waste**

  Owners of limited estates (ie less than fee-simple) are limited in their use of the land (ie cant do things to degrade its value) to protect future interests

Freehold

- Fee Simple Absolute in Possession.
  - Not subject to determination it is held in perpetuity without limit. In possession refers to an immediate estate that can be held now.
  - The alternative is a remainder interest or life interest which is dependent on the life of an individual.
- Land title was originally based on deeds; a written, witnessed record of ownership (trail of contracts).
- In Queensland this has been replaced by the Torrens title system which provides for a system of registration.
- Each registered title is indefeasible.

Leasehold

Crown leases – State grant of leasehold tenure (approx. 75% of Queensland is leasehold land)

Private leases (between an owner of fee-simple and a lessee or a lessee and a sub-lessee)

- A written agreement or contract between two parties which creates a tenancy.
- A tenant is a person(s) holding land under a landlord in leasehold tenure, usually a contractual tenancy for a certain period under which is paid an annual rent as a consideration for the right to exclusive possession.
- Essential elements of leasehold tenure are
  - Privity of estate (same land held by both parties)
  - Privity of Contract (both parties have contractual obligations with each other).

Leasehold

Types of Leasehold Tenure

- Tenant for a term
  - Specific tenancies
  - Periodic tenancies
- Tenant at Will
  - Ongoing until immediately termination by either party
- Tenant at Sufferance
  - one who comes in by right and holds over without right (not a trespasser)
  - Bound by terms of previous lease

Leasehold

Rights and Obligations under Leasehold Tenure

- Written contract is the primary source of rights and obligations between the parties
- Part VIII of the *Property Law Act 1974* (QLD)
  - s 105 – tenant's obligation to pay rent, keep in repair etc.
  - s 107 – landlord's right to enter, repair etc
- Common law – implied terms and conditions
  - Tenant right – quiet enjoyment
  - Landlord obligation - non derogation of grant

Licences

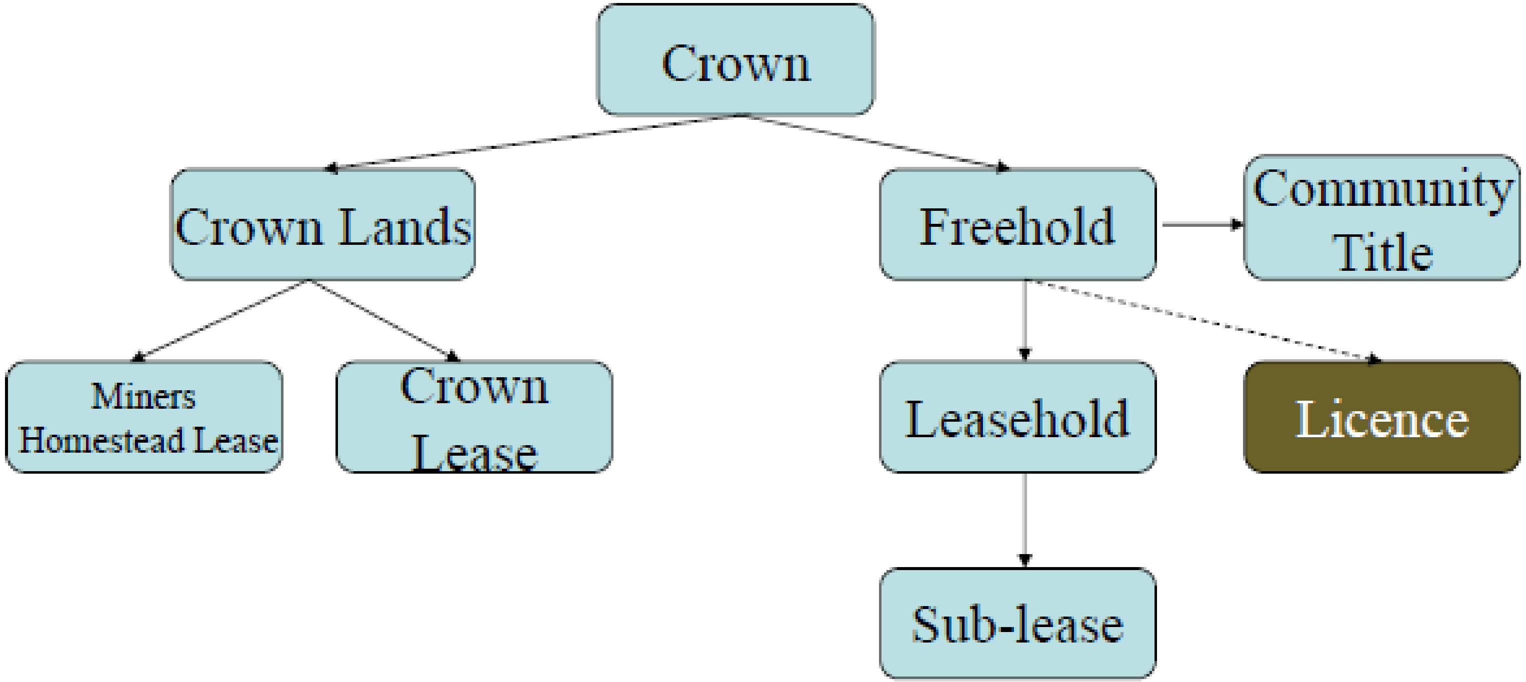
- A licence is a contractual right and merely gives the licensees the right to use the premises for a given purpose and to do something rightfully on the land which would otherwise be a trespass.

- A lease conveys an estate in the land to the tenant, a licence passes no estate in the land to the licensees.

- A lease when granted cannot be revoked (subject to termination rights for breach) - but the grantor of a licence may revoke it at any time, upon reasonable notice.

- A lease can be assigned to a third party in the absence of express stipulation to the contrary; a licence (unless coupled with an interest in land) cannot be assigned.

Freehold – Leasehold - Licence



Native Title

- International law of the 18th century recognised four ways of acquiring sovereignty over a new territory: by conquest, cession, occupation or annexation. Settlement in 1788 was regarded as being akin to occupation of uninhabited lands (not really true though).
- In 1992 the High Court decision in *Mabo v Queensland* rejected the view that sovereignty conferred absolute beneficial ownership of all land on the Crown and held the Crown acquired only a radical title to all land.

Native Title

- In 1993 the States and Commonwealth passed various *Native Title Acts* to validate prior Crown grants and define a process for claiming and recognising native title to lands and waters in Australia.
  - Validated the exercise of prerogative power (ie grant of fee simple) that extinguished native title
  - For native title rights to be recognized continued observation and connect needs to be established (difficult threshold test).
  - Native title is best described as a bundle of rights related to land (hunting, fishing, gathering, spiritual or cultural connection)
  - Native title is inalienable (cannot be sold – only extinguished in whole or part)

DIRECT OWNERSHIP &
INDIRECT OWNERSHIP

Direct Property Investment/Ownership

- Involves investing directly in a specific property or properties, such as purchasing a rental property or commercial real estate.
- Typically requires a significant upfront investment of capital to purchase the property.
- Investors have greater control over the property and can make decisions on property management and leasing.
- Returns can come from rental income, capital appreciation, and tax benefits such as deductions for mortgage interest, property taxes and depreciation.

Indirect Property Investment/Ownership

- Involves investing in property through a third-party vehicle such as a real estate investment trust (REIT) or a mutual fund that invests in real estate.
- Requires less upfront capital and allows for diversification across multiple properties and locations.
- The property is managed by professionals, allowing investors to be passive in their investments.
- Returns can come from dividends and capital appreciation.
- Indirect property investment provides greater liquidity than direct property investment, as shares in a REIT or mutual fund can be easily bought and sold on a stock exchange

CORPORATE REAL ESTATE & INVESTMENT REAL ESTATE

Corporate Real Estate & Investment Real Estate

Ownership Objective

Corporate Property

- Business Base
- Corporate Statement
- Enabler of Business
  - Short and Long-term property solutions
- Infrastructure Facility

Investment Property

- Return on Investment
- Diversification by
  - Location
  - Sector
  - Size
- Direct and Indirect
  - AREITS
  - Syndicates

Real Estate – Space Market

- Rents are determined by the property features in the ***space market***:
  - The market for usage (or the right to use) real property (land and built space)
  - Also referred to as the rental market
  - Reconciles occupier demand with investor supply
  - Occupier demand can be very sensitive to the features of each property
  - Often less insensitive to changes in rent

- **Demand side –** individuals, households, and firms that want space for consumption or production purposes

  i.e. student renting an apartment, law firm renting office space

- **Supply side** – real estate owners who rent space to tenants.

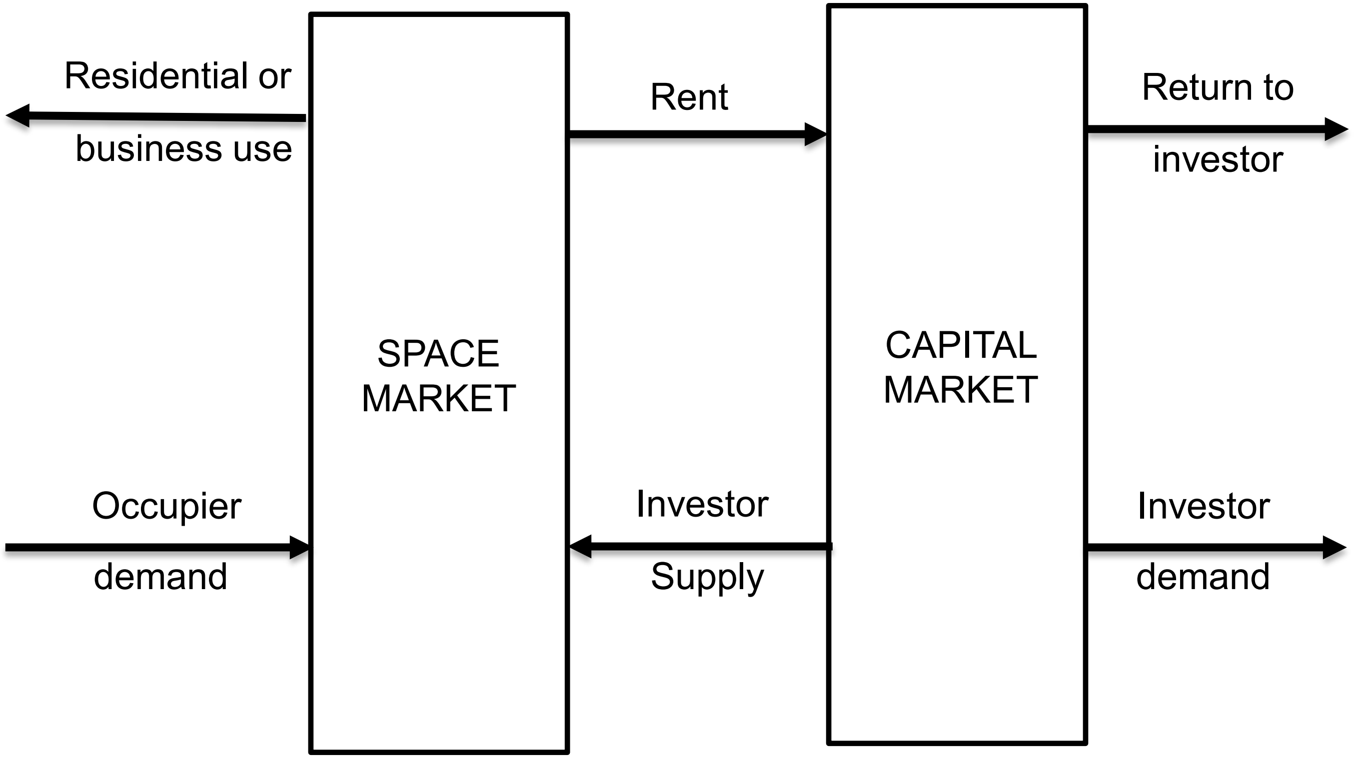
  i.e. shopping centre owners letting space to retailers

Real Estate – Capital Market

- Investment decisions are made in the ***capital market***:
  - Investors can use their own and borrowed capital to earn a rate of return from rented properties, depending on alternative investments and interest rates on borrowings.
- The asset market/ property market is the market for financial ownership of real estate assets
- Assets consist of claims to future cash flows (rent).
- Property competes with other forms of capital assets such as stocks and bonds for the allocation of capital

Space Market & Capital Market

The capital and space markets are driven by different factors but are linked by their rents:



Investment Real Estate

Three key features of income producing (investment) properties:

1. Location
2. Buildings
3. Tenants

Investment Real Estate

1. Location:

- At the city or regional level, the elements of the location to investigate are the strength of the *economic base* and *demographic features.*
- *Suburb level* – occupants will pay more to be amongst compatible, safe and prestigious buildings

- A good location has an *element of monopoly:* cannot be replicated elsewhere
- "Prime" locations have more stable demand and lower vacancy risk than fringe or emerging locations
- Zoning and town planning controls can add potential to a property

Investment Real Estate

2. Buildings:

- To produce a secure, growing income, buildings should be *functional* for current users and be *adaptable* to the changing needs of future occupants.

- Needs of residential tenants will vary slightly overtime – norms and fashions change
- Needs of business tenants change through use of technology to meet needs of customers (manufacturing, provision of services, retail)
- Demand tends to be *'price inelastic'*
  - Tenants will choose a building based on family/business requirements that are not sensitive to modest changes in rent
- Tenants needs change over time - buildings may become obsolete over time and no longer attract tenants of a certain calibre

Investment Real Estate

2. Buildings:

- Environmental sustainability affects rental properties:
  - Buildings that waste energy are more expensive to operate = lower net operating income to investors
  - Tenants are now demanding high standards of energy efficiency and assurances of healthy working conditions in the buildings they lease
  - Government funding may be available to make existing buildings more efficient – e.g. solar hot water grants

Investment Real Estate

3. Tenants:

- Rent is paid in accordance with the *lease terms* provided that the tenant can afford the payments.

- Leases provide a degree of certainty to the income stream for the investor.
- Could be compared to a bond or debt instrument – contractual obligation for payment

- Non renewal of lease may lead to *vacancy* or expensive *leasing incentives* to attract new tenants

Investment Real Estate

3. Tenants:

- Lease clauses:
  - Lease length
  - Basis of rent review: fixed, indexed, ratchet, cap, collar
  - Responsibilities - opex, maintenance
- Tenants:
  - Financial strength - risks around rent payment
  - Potential growth – rental growth, space requirements
  - Potential vacancy – risk of vacancy due to default or end of lease

RISK MANAGEMENT

Sources of Risk

Sources of Risk

1. Market Risks:

- Affect almost all properties in the submarket, but often to a different degrees

- Partial protection from long term leases – rents with fixed or CPI increases

- Risks from market imbalances can arise form:
  - Changes in supply – overbuilding
  - Overconfidence in investors or lenders- lower yields and unstable prices
  - Changes in demand for goods and services which dominate the regional economy

- Results:
  - Declining rents
  - High vacancies
  - Rising yields

Sources of Risk

2. Financial Risk:

- Arise from the financing of the property. Typically financial risks augment other risks and are the main reason property investments may become “insolvent”.

- Risks:
  - Volatility associated with leverage
  - Costs of loan default
  - Interest rate increases
  - Inability to refinance expiring loans

Sources of Risk

3. Property Risk:

- Risks that affect the property investment but not the market as a whole. May damage location, buildings and tenants.

- Risks:
  - Location – rental and capital value impacts: trading potential of a retail store impacted by reduced pedestrian access
  - Building failure - unexpected running costs, claims against owners allowing contaminating uses etc
  - Soundness or ‘covenant’ of a tenant – checks on financial stability of a tenant prior to purchasing a property
  - Many building risks can be insured against

Sources of Risk

4. Other Risks impacting property ownership:

- Inflation risk
- Management risk
- Interest Rate risk
- Legislative risk
- Environmental risk

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Questions?