

## **LEASEHOLD PROPERTY AND INVESTOR RISK MISESTIMATION**

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### **ABSTRACT**

#### **Problem/Purpose**

Investors may not adequately take account of the scale of risks associated with leasehold property and the risks this poses to the value of the ground leasehold. While suboptimal behaviour is suspected of being the more significant cause of investor misestimation, ruling out asymmetric information as a more prominent problem is a necessary first step.

#### **Design/methodology/approach**

A series of semi-structured interviews will confirm (or not) that suboptimal behaviour is the central reason for investor misestimation. This method will draw out the more significant factors around investor behaviour types around this specialised asset class. This study is a precursor for a future study where a specific circumstance may be used to test investor perceptions. Therefore fully understanding such investor behaviour around ground leaseholds is critical.

#### **Findings**

Preliminary findings indicate asymmetric information is not the central issue; rather the way certain investors make decisions is of more relevance. There appears to be different groups; those who are fully informed and those who are perhaps less so well informed. Further work is required to understand the behaviour of investors and why some appear to make good decisions and others do not. Further interviews are therefore required to help better explain what occurs in the thought processes of investors when they purchase a property.

#### **Research limitations/implications**

Despite careful design, this qualitative research style may introduce some bias from the researcher.

#### **Takeaway for practice**

Investors and other who contemplate the purchase of a leasehold property (lessees interest) should inform themselves fully as to the risks.

**Originality/value**

Investor behaviours around this asset type are less commonly studied. Such research will therefore be of considerable benefit.

**Social Implications**

Auckland and many other cities within the Pacific Basin have experienced significant price growth in recent years. Leasehold property may provide a viable alternative for purchasers who cannot afford fee-simple property. Understanding the behavioural tendencies is therefore important.

**Keywords:** Leasehold, suboptimal, risk.

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## INTRODUCTION

This study is concerned with residential ground leasehold property, where the owner of the land (lessor) receives land rent from the tenant (lessee). The emphasis of this research is on investor decision making for the lessee's interest. Typically, the lessee owns the buildings and other improvements, so the lessee pays rent for the land only and not any buildings.

While freehold values can fluctuate with market movements, most people are aware of these risks. Freehold properties do have specific risk such as construction quality issues. Leasehold properties can be subject to the same risk factors and have additional risks relating to the lease agreement.

This greater risk is demonstrated in sales statistics. Although leasehold properties make up approximately 1.4% of total properties according to Land Information New Zealand (2015) they only comprise 0.77% of residential sales based over a 10-year period (Real Estate Institute of New Zealand, 2015). Despite this, they make up approximately 3.85% of listings for mortgagee sales based on Trade Me Property (2015) data over the past 10 years. Trade Me is a New Zealand equivalent online trading company to eBay and has a large market share of on-line property listings.

How investors interact with these more complex property types is the focus of this research. Investors will be studied because they are, or should be, more informed about property issues. The term "investors" in this paper means people who own an additional property to their place of usual residence. Members of the public who have never owned an investment property are not the subjects of this research. Finding that a non-investor does not understand leasehold property would not be a surprising finding. Therefore, investors are the group selected for this study.

New Zealand leasehold property issues are often noted in the literature. Mandell (2002) for example refers in his Swedish based work to seven New Zealand leasehold related references out of twenty-eight references in total. It is speculated that the variety of leasehold agreement types may contribute to the misunderstanding as compared to other countries. Christiansen (1996) details some of this variation in New Zealand lease types (pp.203-205). New Zealand is therefore an interesting case study with investors having to understand differing lease type variation.

Contrasting the New Zealand situation of significant lease and owner variation, other countries have greater government control creating a more consistent understanding amongst the population. Hong Kong would appear to be such a market where leasehold property is better understood in general; for example see Teng *et al.* (2013). So New Zealand leasehold property has special challenges relating to factors including lease type variation and different lessor owners for lessee investors to interact with.

## LITERATURE REVIEW

Leasehold property has been investigated from a number of different perspectives. Jefferies (1997) examines lessee and lessor affordability models. Building on this work Mandell (2002) connects the lessee and lessor return models into a combined model that is Pareto efficient (p.145). Mandell (2001) investigated if leasehold property is mispriced. While leasehold property usually sells for less than freehold equivalents, Mandell's study examined if there were additional discounts observable. In a sample of 16 leasehold properties he found there is no additional discount apparent (Mandell 2001, p.50).

Mandell (2002) outlines how the rent review process could favour the land owner who possesses greater knowledge than the lessee (p.153). This creates a possible information asymmetry problem. A famous illustration of the information asymmetry problem is explained in the work of Akerlof (1970). The example Mandell (2002) discusses concerns Swedish municipalities who own the majority of leasehold land and also administer the zoning regulations (p.153). They therefore have superior knowledge of the market supply and demand factors. If underlying economic conditions allow, a change in zoning can result in significant land value increases upon rent review. Determining the value of the land is important because often, the ground rent is set as a percentage of that land value.

Zoning changes can have a serious impact for lessee cash flows. Walker (2010) outlined in a New Zealand example where a zoning change led to a greatly increased land value and ground rent. Despite this a heritage designation prevented a small character building being removed. Under such circumstances, the ground rent could be greater than the building occupation rent. Therefore ground rent increases can have significant impacts on the sustainability of investment cash flows.

Alternatively there is an argument that investors can discover relevant information and inform themselves appropriately. In other words information asymmetry is not the more significant theoretical explanation. People can discover relevant information; however for some reason do not wish to fully investigate the relevant leasehold issues. It is conjectured that they take mental short cuts when they make decisions. These mental short cuts have been termed heuristics as described by Tversky and Kahneman (1974). These people make use of what they know, or what is readily available to their mind. This has been termed the availability heuristic by Tversky and Kahneman (1973).

Another related heuristic is discussed by Slovic (1987) and relates to the concept of affect. Feelings can influence judgement of risk. Favourable feelings can result in low risk perception, while unfavourable feelings results in a greater risk perception (Slovic and Alhakami 1994). Slovic and Peters (2006) outline how people are insensitive to probability in events such as lotteries (p.324). The possible good feeling of winning a lottery makes people less sensitive to the actual likelihood of that happening.

Essentially the affect heuristic is concerned about how imagery can impact on decisions. The affect heuristic and availability heuristic are seen as being interrelated (Keller *et al.* 2006, p.637). In essence the image that someone has in their mind is related to how available that image is to them. Therefore there is a close relationship between these two heuristics which may be difficult to distinguish in practice. While decisions can be rationale, there can be some limitations relating to their ability to recall available information in a fully accurate way. The implication is that decisions made may not be fully rationale all of the time.

Hirshleifer (2001) indicates there is much opportunity to enhance research through careful application of psychology principles (p.1576). Kliger and Kudryavtsev (2010) have investigated the availability heuristic in relation to the stock market. They examine daily market returns as a proxy for availability (p.55). They confirm that positive stock price responses to recommendation upgrades are stronger when accompanied by positive stock market index returns. Corresponding patterns exist for negative returns (p.62). Attention grabbing stocks are the central focus for Barber and Odean (2008). They find individual investors overall buy more of these attention-grabbing stocks (p.785). Other research topics that use the affect heuristic include the justice (Stalans, 1993), education (Fox, 2006) and health (Triplet, 1992).

That the human mind can operate in sub-optimal ways therefore is not in question and it would appear that leasehold property is suitable to be studied in relation to affect and availability heuristic theory. Nevertheless the applicability of this theory is explored as part of the early research stages.

## **METHODOLOGY**

A semi structured interview approach will be used for this research. This method has in part been driven by a lack of available quantitative data. While information such as sale price, sale date, floor area and bedroom numbers are readily available other relevant variables are not. These missing variables include the current contract ground rent, the ground rent if reviewed, and other details such as rights of renewal. While some variables could be determined by searching legal documents some details such as the current ground rent level could be confidential. Therefore a lack of quantitative data means a more qualitative research method needs consideration.

Furthermore the initial research dilemma for confirming either information asymmetry or sub-optimal behaviour as the most likely theoretical explanation requires resolution. Interviewing investors and others who can help explain what is occurring in the leasehold property market is the best approach. To date there is not enough research on leasehold property to definitively conclude if information asymmetry or sub-optimal behaviour is the more likely theoretical explanation. A semi-structured interview approach is used where the respondent provides the reasons for any problems. Preselected answers for the investor to choose from will not be used. The idea is that the investor tells the researcher what the problems are and not the researcher suggesting to investors what the problems could be. These investor explanations will enhance our understanding of the critical issues. Martin and Turner (1986) outline that such a qualitative research method, conducted at the start of a research project can be seen as an effective pilot study, better supporting any future research endeavours (p.143).

Examination of theory has already led to the requirement for examination by a semi structured interview approach to help reconcile which theory is more appropriate; asymmetric information or theory involving sub-optimal behaviour. The semi-structured interview approach is therefore not being used to have theory evolve; in this respect this method does not conform to the Glaserian style of research. Rather the "Straussian" style of qualitative research as detailed by Jones and Alony (2011) is advocated for this research initiative (p.99). This approach is more practical for this research undertaking where ideas on theory have already influenced the research direction. Explaining what is occurring with investors when they purchase ground leaseholds is the focus of this research.

The suggested steps for this Straussian research style are recorded by Corbin and Strauss (1990 ). These include detailed descriptions of how to collect data, develop categories, theory considerations and how to code data (pp.6-16). More recent work indicates that researchers should “...stay within the general guidelines ... and use the procedures and techniques flexibly according to their abilities and the realities of their studies” (Strauss and Corbin 1998, p.295). In addition, this investigation will also use qualitative analysis software such as NVivo to help organise, code and ultimately more fully understand what is occurring.

## **RESULTS AND DISCUSSION**

The process of interviewing investors is underway with four interviews now complete. More interviews are required to improve the interpretation of important issues. Coding the written discussion records around important themes will take place once more interviews have been completed. Therefore the findings as discussed below are of a preliminary nature and are subject to further refining.

Professionals contacted to arrange interviews with investors are often reluctant to assist. This is not unexpected given the sometimes tentative nature of business relationships. Nevertheless one explanation as to why assistance was denied is informative. This gatekeeper worried that facilitating a client interview may encourage his clients to “think” about their leasehold investments. This touches at the very heart of this research – what do investors think about exactly when they deal with leasehold property investments.

Ground rent reviews are identified as an event where investors are exposed to risk and there appears to be varying outcomes for different investors. Some investors fully appreciate the risks. Others appear to be less well informed and have rent reviews resulting in unexpected rent increases. This may force these investors to sell their property or raise additional finance. A clear explanation as to the exact thought processes of these less well informed investors go through is yet to emerge. Nevertheless at this early stage there would appear to be issues around the sub-optimal behaviour of certain individual investors, rather than for the market as a whole.

The way ground leaseholds are sold is important and requires further probing. Some investors purchased their leaseholds as part of various investment schemes. Some interviewed suggest that this process did not encourage full discovery of relevant facts. Despite this other investors who appear to misunderstand their investments did not purchase through these schemes. While relevant information to help them is possible to discover they do not seek it. Exactly why will be further investigated as the study develops.

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