

**Economic and Employment Council
Pre-construction Task Force**

The Land Premium Process

The Problem

- Hong Kong's leasehold system means that any lease modification premium is a matter of negotiation and as Landlord, Government is under no obligation to reach an agreement.
- The principle of valuation for lease modification premium is the cleared site value, irrespective of the actual condition of the site or the actual acquisition and clearance costs.
- Whilst a simple system that has served Hong Kong well in the past when the increase of development potential was substantial, there is reason to believe the current system is now causing a blockage in the redevelopment process and is actually discouraging urban renewal and redevelopment.

The reasons

- The actual cost of site assembly is greater than the "before value" credit as a cleared site basis. For example the cleared site value of an industrial site is likely to be well below the cost of the acquisition of an industrial building plus the cost of clearance. The credit an owner will receive in the lease modification process will therefore be below cost and unless an owner is confident prices rise with inflation the lease modification premium will be too high resulting in no agreement, no land premium for Government, no urban renewal and no new supply of commercial or residential accommodation.
- Coupled with this "before value" problem is the current approach adopted by Lands Department to the "After Value". In order to avoid criticism (audit/legco/ombudsman) Lands Department will seek the "Best Evidence" – which is correctly the evidence of land auction sales, and adopt the highest possible "After Value".

- A further complication is that certain “After Costs” are ignored by Lands Department in premium assessments. These costs can be the actual engineering costs necessary to create a site (*rather than a lower Government estimate*) but are more likely to be the costs (*actual or estimated*) of certain GIC facilities “offered” by developers (usually at the request of Government departments).
- Herein lies the dilemma. Land Auctions being open and competitive must provide the “Best Evidence” of land prices. – But when supply is limited some developers are bullish as the future market and base their bids on future increases in eventual sales prices. This has been the outcome of the last two Government Land Auctions.
- By adopting the highest possible “After Value”, ignoring certain fixed costs (GIC) and under estimating the real acquisition costs by adopting a cleared site “Before Value” basis results in a premium that is rarely acceptable.
- The result is stalemate – no agreement means no premium – means no new supply through redevelopment – means higher land prices at Government auction where there is no “Before Value” issue or need for agreement (i.e. delay) which leads to even high “After Value” assessments.

How to end the stalemate?

1. Change the basis of assessment – allow actual acquisition costs in the before value i.e. full credit and
2. Introduce some form of arbitration to prevent Lands Department from adopting a “take it or leave it” attitude which generally avoids criticism.

Attached is a paper that more fully explains the Valuation dilemma using recent land auctions to illustrate an increasing problem.

The Valuation Dilemma

- Now armed with current hot land sale comparables Lands are now going to use them as best evidence for the “after” value in any land exchange/lease modification case. Professionally it is hard to argue against this as direct sales evidence of development sites such as those achieved at auction sale prices are usually accepted as being the best form of comparable, superior to using residual valuation or DCF methods.
- The problem facing the development industry is that the prices achieved in the last two auctions reflect a serious pent up demand for land that has resulted in the bid price overshooting when analysed back to today’s selling price for finished flats and today’s construction costs. ‘Flour is now more expensive than bread.’
- The dilemma is that we in the development industry have created the new levels of land value predicated on a continued rise in flat selling prices through the construction period and Government valuer’s have little or no choice in adopting these new levels of value.
- With the ‘Hang Wah Chong’ decision to back them Government can adopt a ‘take it or leave it’ attitude neither do they have to establish the reasonableness of their demands for premium! So we face an uphill battle.
- If there is little room to manoeuvre in the ‘after’ value assessment then I think there is room for improving the values adopted for the assessment of the ‘before’ value. Currently both are done on a cleared site basis. For the ‘after’ value that is correct but in the ‘before’ situation this can result in under assessment because the following elements are not included:-
 - a. Legitimate ‘hope value’ embedded in the purchase price if the existing zoning plan indicates a higher intensity of development;
 - b. the value of the any buildings that may exist and had to be included in the purchase price;
 - c. the costs of obtaining vacant possession and demolishing any existing building and
 - d. the time taken and the carrying costs involved.

- Put simply if Government insists on charging top dollar in the 'after' value but does not give full credit in the 'before' value it is hard to see how any premium offers can be accepted as the projects will not be economically viable.
- Another issue that is causing concern is the trend for Lands to unilaterally withdraw offer terms where the time limit for acceptance has yet to expire because they feel a subsequent land auction result justifies a revision of the premium. This trend is seriously eroding our 'level playing field' style of doing business by creating huge uncertainty and must cease. Would they do the same in reverse if the market fell? I think not!
- In spite of claims to the contrary and in direct contradiction of their 'transparency' objective as set out in the Vision and Mission statements Lands are still very difficult to negotiate with when it comes to a fair exchange of information and methodology of individual valuations.
- In the current climate of civil service defensiveness where there is extreme reluctance to be seen to be giving any one applicant an advantage as compared with another the only way out is to establish an agreeable 3rd party method of adjudication may be by an Independent Assessor for premium up to a certain limit (\$50 – 100m?) and referral to the L.T. for the bigger cases.
- However this would require a paradigm shift by both the Government and the development industry to accept the outcome of such assessments. But now may be the time if we want to move this process forward. Are we in the development industry ready to accept this?