



Boating Industry Association
of New South Wales Ltd
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POSITION PAPER ON SUSTAINABLE RENT

**Mark Hewitt. Marina Association of NSW Chairman
August 2008.**

To be read in conjunction with the Pitcher Partners Report to the Boating Industry Association on Sustainable Rent for Marina Concession Holders

SUMMARY AND CONCLUSION

This paper provides our members a framework for rent negotiations with Government Authorities. Our members advise that the Authorities are demanding rents which are much higher than those which allow them to maintain and improve infrastructure. Furthermore, the valuation-based approach used by the Authorities in periodic rent reviews creates considerable uncertainty which impedes investment in new marina infrastructure. This paper explains why rent based on a percentage of revenues provides more investment certainty and allows the Authorities and lessees to share the financial rewards from improvements in the marina.

Pitcher Partners were engaged by the BIA to advise on the merits of our position and to develop a simple financial model for members to calculate sustainable rent expressed as a percentage of revenue for their marina. The model applies market-based equity returns to capital expenditure on new and improved marina infrastructure to determine the operating cash flow required by marina operators. Any excess of operating cash flow over the required return can be returned to the Authorities as sustainable rent. Pitcher Partners obtained detailed financial information from 5 marina operators who have invested or plan to invest in new and improved infrastructure. Pitcher Partners reported that even rents equal to 6% of turnover were unsustainable for those marinas.

Pitcher Partners concluded that “real growth in marina revenues in excess of movement in CPI is required in order to support rent levels of between 6 – 8 % of turnover for a 25 year concession term”. The BIA recommends this range as a reference point for negotiating rent on berths and sub-tenancies. Directly provided services such as slipway, shipwright and mechanics should attract rent equal to 2% of revenue, reflecting the significant costs of labour, materials and parts in deriving that revenue. The percentages may be adjusted to take into account individual circumstances such as the number and size of berths, exposure to waves and weather, water depth and the amount of land-based infrastructure such as car parking and other amenities. Public access to

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members of



53 Hume St , Crows Nest NSW 2065
PO Box 1204 Crows Nest NSW 1585
Australia
p. (02) 9438 2077
f. (02) 9439 3983
e. info@bia.org.au



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amenities, recreational areas and fuel facilities should be taken into account to reduce rents.

The recommended percentages are at the upper range of rents paid by marina operators to US and Canadian authorities. Those authorities explicitly recognise that the lease is in substance a concession to develop a marina and that a percentage of revenue is the appropriate basis for paying rent on such concessions.

Members may prefer to pay a single composite rate on total revenues derived from the leased area or different rates according to whether the revenue is passive (berths and sub-tenancies) or active (directly provided services such as slipway, shipwright or mechanics). Members may prefer rent calculated on revenues received each year or CPI indexation until the next agreed rent review. The BIA would be very pleased to assist government Authorities verifying both the merits of our position and the financial and empirical integrity of the model used to justify the recommended ranges.

WHY RENT BASED ON VALUATION IS NOT SUSTAINABLE

It is understandable that the Authorities would favour calculating rent as a percentage of the unimproved capital value of the land (“UCV”). The Authorities are providing bare dry land and seabed whilst the lessee provides all the improvements and takes all the financial and operating risks. However rent as a percentage of UCV results in the following uncertainties.

Valuers are required to look at the development potential of the land

Because there are almost never any comparable sales of unimproved land zoned for marina use, valuers attempt to ascertain the development potential of the land taking into account any zoning restrictions. It is arguable that s143(1)(a) of the Crown Lands Act also requires the Dept of Lands to take into account restrictions imposed by the lease itself.

This is an extremely subjective exercise which assumes that the marina operator will overcome all the onerous planning, environmental and regulatory approvals to achieve the marina’s potential. The marina operator will be penalised if the UCV is based on a potential use which is very unlikely to occur.

The valuation does not take into account the limited rights of the marina operator

Valuations are usually performed on the assumption of a perpetual land right. However the marina operator has a concession for a fixed period within which any investment must be recouped out of operating cash flow.

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There is considerable uncertainty in estimating construction costs, financing costs and risk premium

There may be considerable differences of opinion as to the type and cost of construction and the risk premium required by the marina operator.

Market price is not a reflection of sustainability

Valuations can be influenced by market sales. Recent sales of both leasehold and freehold marinas have been at prices up to 20 times their latest profits (a 5% yield). These extreme values cannot be supported by the marina's cash flows. The purchasers may have had other motives for paying such high prices. Furthermore, at current commercial interest rates of 10% the ability of the marina's cash flows to service any borrowings is severely limited.

The marina industry has witnessed cycles (the last one in the early 1990's) where inflated values are followed by interest rate increases and bankruptcies. This has been to the long term detriment of the quality of marinas and the level of service offered to the boating public.

The rate applied to the unimproved value is also uncertain

The valuation industry has applied rates from 3% to 8% of UCV to calculate rents. IPART used 3% as a basis for rent on UCV of residential waterfront leases. This indicates fundamental differences of philosophy in determining the rate.

Calculating the market value of the leasehold is extremely uncertain when the lessee owns the adjoining freehold.

Whilst the owner of the seabed absolutely depends on the adjacent freehold to realise its value, the owner of the freehold does not necessarily depend on the seabed to realise the highest value of the freehold. Other uses of the freehold land are becoming increasingly attractive. Commercial marinas on freehold land in Sydney Harbour, Pittwater and Botany Bay are increasingly under threat from residential development.

The value of the marina over the seabed is dependent on both access from the adjoining freehold and the carpark and facilities on that freehold which are necessary to support the structures over the seabed. The value of the lost opportunity of alternative uses of the freehold land and the cost of the facilities dedicated to the marina should both be taken into account in valuing the marina on seabed leasehold.

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Marinas may actually reduce the residential value of adjoining freehold land, as evidenced by the recent Breakfast Point conflict. Removal of the marina facilities at The Anchorage in Newport would increase the value of the apartments on the land which is used to access the marina. In this case there is a very strong argument that the value of the seabed can only be determined by other uses of the seabed. At best this may be as a site for swing moorings with no access to land-based facilities.

The uncertainty of rent reviews will greatly inhibit investment in new facilities

Neither banks nor investors will provide capital if the way rent is calculated is uncertain. The rent to the government from large infrastructure such as tollways and airports is always a known function of revenues derived from traffic volumes. There is not one instance where the landowner's rent is determined by UCV.

WHAT IS THE BASIS FOR A SUSTAINABLE RENT?

Sustainability can only be determined by looking to the future. Past cash flows only provide an indication of future cash flows and market values provide even less guidance to sustainability. How a marina was, is, or will be financed is also no guide to sustainable rent for the following reasons:

- Current financing usually relates to the original purchase price
- Operators have often paid down loans or refinanced since the original purchase
- Rent payments can only be sustained through future cash flows which in turn depend on future maintenance, replacement and expansion of infrastructure as well as future demand for the facility from the boating public.

In the long run rent is only sustainable if the landowner receives fair compensation for what is provided. The Authorities provide bare land and/or seabed and bear no risks and incur no costs associated with ownership. The Authorities concede the exclusive rights of ownership to the lessee for a fixed period. The lessee exclusively bears the following responsibilities:

- Expertise and risk in formulating development applications
- Securing the funds to get to the construction stage
- The risk that the construction is on spec, on budget and on time
- Market risk that the revenues match forecasts
- Operating costs
- OH&S, public liability, environmental and operating risks

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The lessee may also provide significant public benefits including public access to the marina, fuel facilities, public amenities and areas for public recreation. The cost of installing and operating facilities available to the general public needs to be taken into account in determining sustainable rent.

In other sectors where the government provides a concession to the private sector, such as infrastructure and gambling, rent is always a function of the amount of revenue received by the landowner or concessionaire. The government shares the benefits when revenues improve and shares the pain when revenues decline. This is also the case with franchises granted in the private sector.

WHAT IS A SUSTAINABLE RENT?

The landowner should receive proper compensation for granting the opportunity to the lessee to develop and operate the facility. The landowner shares the revenues generated by the enterprise of the lessee but does not take further advantage of the ability of the lessee to generate those revenues in a profitable manner. From both a financial and public policy outcome it is necessary that the lessee optimises the potential of the site. This will be recognised in the revenues generated by the public's willingness to use and pay for the facility.

Pitcher Partner's model quantifies the value provided by the lessee, after taking into account appropriate compensation for undertaking the risks of constructing, financing and operating marina infrastructure. Pitcher Partners have been provided detailed information by 5 members who have invested or want to invest in improved and/or larger facilities. The information from each marina was fed into a model to establish a sustainable rent. All construction, operating and financial inputs in the template were validated against known industry norms (for example standard per square metre costs for constructing berths, revenues consistent with market berth rates, standard operating costs etc). Pitcher Partners have also provided a paper which justifies both methodology and key financial inputs used in the model.

The model indicates that sustainable rent on berths and sub-tenancies at a 100 berth marina should equate to 6% of revenue. Sustainable rent on revenue from directly provided services such as slipway, shipwright and mechanics should equate to 2% of revenues, reflecting the significant costs of raw materials, parts and labour used to derive that revenue. Fuel revenues may not attract any rent, reflecting the substantial costs of infrastructure and fixed operating costs as well as environmental compliance costs and risks.

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The BIA advises members to negotiate their percentage based on the specific circumstances of their marina. For example a smaller marina would attract a lower percentage due to the fact that fixed costs represent a higher proportion of revenues. Other site specific factors include exposure to weather and wave action, water depth and the size and quality of dry land facilities provided by the marina operator such as car-parking and public amenities.

International benchmarking

The BIA has collated a large body of evidence demonstrating how US and Canadian authorities calculate rent on the unimproved seabed and adjacent dry land. For example the Ontario State authority's position is summarized in the following extract from the Memorandum of Understanding with the Ontario Marina Operators association:

As supported by the report prepared by the Simmons Group and through extensive research and discussion with the OMOA it was determined that a fair rate of return to the Crown would be 1-2% of the gross revenue realized from the rental of dockage only.

The Government of British Columbia contains the following statement in its Crown Land Use Operational Policy:

The annual rental for marinas and yacht clubs is 3.5% of gross potential income in the first 15 years of tenure and 4% of gross potential income thereafter.

The US Army Corps of Engineers, which has enormous landholdings throughout the United States, charges rent using its Revised Graduated Rental System. The rent is based on 'the total of the concessionaire's receipts from business operations conducted on the premises, including receipts of sub-lessees and licensees'. The rent starts at 2.4% increasing to a maximum of 4.6% above \$5m.

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