

**Legal Considerations
Pertaining to a Leasehold
Structure for Public Land
Developments – The Waterfall
Estate Case**

UCT-Nedbank Urban Real Estate Research Unit

Legal Considerations Pertaining to a Leasehold Structure for Public Land Developments – The Waterfall Estate Case

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1. Introduction

The UCT Nedbank Urban Real Estate Research Unit is a unit at the University of Cape Town that focuses on the economic and financial issues facing real estate in Sub-Saharan Africa. The Unit focuses on the following four themes:

- Urban Real Estate Markets, Dynamics & Trends
- Urban Real Estate Investment & Finance
- Urban Development & Management
- African Urban Real Estate Markets

These themes are operationalized through research, data management, training and advisory services. A defining objective of the Unit is to facilitate greater interaction, communication and partnerships between the private and public sectors. As a result, the Public Land Development Research Programme (PLDRP) was established with funding from the Johannesburg Property Company (JPC). This research was undertaken through the PLDRP.

2. Background

Municipalities and other public entities in South Africa often dispose of land they own to generate income for municipal purposes and/or to achieve broader economic and social objectives. To date, the most common method to do this has been to dispose of the land on a freehold basis. However, this approach has been questioned in that it is argued that the municipality may forego higher annuity income in the future and the long-term assets are lost in perpetuity.

Despite these concerns, there has not been a systematic assessment of the advantages and disadvantages of disposing of public land through leasehold versus freehold methods and how such disposals should be structured in each case.

In response to this, the PLDRP has developed a financial model to assess the optimum length of a public land development lease. In the process of receiving comments on the above model from various public and private entities, a number of issues were raised pertaining to the terms and conditions of the leases and the degree to which municipalities can enter into leasehold agreements with private property developers.

Recent private sector developments, such as the Waterfall Estate in Gauteng, undertaken in terms of a leasehold arrangement, presented an opportunity to investigate such issues through the review of this case.

3. Research Objectives

The Waterfall Estate is a successful development undertaken using a leasehold model between private parties. Through this process, numerous issues and challenges have been resolved such that a leasehold structure has been designed that addresses the needs of the land-owner, developers, financiers and buyers and end-user tenants. As a result, the objectives of this research were to review and understand the structure of the Waterfall Estate case in order to assess whether municipalities could dispose of their land using a similar leasehold model. A particular focus was placed on the security offered by the lease agreements, the sale, cession and sub-letting conditions of the lease agreements and what happens at the end of the lease terms.

The research methodology involved the review of the legal documentation related to the Waterfall Estate Case, review of the legislation and regulations related to long-term leasing of municipal land and interviews with developers, lawyers, banks, municipal officials and National Treasury officials. Various legal agreements related to the Waterfall Estate Development were not made available for the research as the confidentiality of these private agreements needed to be respected. However, the parties involved were prepared to give some insight into the fundamental principles on which the Waterfall Estate development proceeded and is still operating.

4. The Waterfall Estate Development

The Waterfall development is in Gauteng and encompasses 2 200 hectares of land, which stretches from Woodmead to Kyalami and Vorna Valley, bordered in part by the suburbs of Buccleuch and Sunninghill. It covers both sides of the N1 and it is the biggest property development in South African history. The original land was larger than the now 2 200 hectares, as the government expropriated portions for the Buccleuch interchange and the Eskom's Megawatt Park.

The land was originally owned by the Gibson Brothers, who arrived in South Africa from England in 1871. They bred cattle and ran a stagecoach business between Johannesburg and Pretoria. In 1934 the farm was sold to a trader Moosa Ismail Mia. He registered the land in the name of the Witwatersrand Estates Limited (hereinafter referred to as "the owner"). The shareholder of the owner is the Waterval Islamic Institute.

When the Mia family decided to develop the land, it had to be done within the framework of the Waterfall Islamic Institute's religious requirements. The Waterfall Islamic Institute is a charitable organisation dedicated to providing resources for the education of underprivileged children and the operation of social projects, shelters and feeding schemes. The land can never be sold. Only leasehold agreements can be entered into based on the religious endowment, known as a Waqf. The profits from the land must be used for charitable purposes or for public good.

As a result, the owner commenced the development of the land on 99-year leasehold basis. The development proposal included a mix of large-scale retail, commercial and residential developments, schools, hospitals, hotel, training colleges and including a helicopter airport.

The challenge was to achieve leasehold structures that would satisfy the requirements of the developers, banks and the commercial, industrial and residential end-users (tenants and purchasers). For this to occur, the leasehold agreements would have to work as closely to ownership as possible. While, the corporate divisions of the banks have historically provided finance secured by mortgages over registered notarial deeds of lease, they have been slow to bring creative mortgage products to the residential property market. However, the owners were able to get the major commercial banks to introduce a lease mortgage finance product to enable people to buy property on a 99-year leasehold basis in the Waterfall development. The lease mortgage works similar to a traditional mortgage. It is also payable over twenty/twenty-five years and is available at similar interest rates. The notarial deed of lease incorporates rights and benefits in favour to the bank in the nature of a stipulatio alteri¹.

5. The Institutional and Legal Structure of the Model

The model was structured as follows:

- The owners of the land created special purpose vehicles (SPVs) (hereinafter referred to as “Propco’s”) to establish and manage the development of various pockets of land on a 99-year leasehold basis.
- Through this process, the original farm was broken into registerable portions that were transferable into the specific SPV’s for development purposes. The shares in these SPV’s were registered in the owner’s name.
- Dispensations were achieved to be able to notarially register leases over pockets of the land.
- The owners joined forces with developers such as the Atterbury Property Group and Century Property Developments, hereinafter referred to as “Devco”, to realise the Waterfall development.

¹ The lease contract conclude between party A and B includes rights and benefits in favour of the bank, who by accepting the benefit becomes a party to that lease agreement so that A and the bank become bound to each other.

- The owner sold the rights to the Devco to develop portions of the land through a series of land availability and development rights agreements. These agreements:
 - were based on agreed master development plans drawn up by the owners and the Devco;
 - detailed the responsibilities relating to the development of the infrastructure, the township establishment, construction parameters, marketing and timeline for completion of the development;
 - detailed the agreed consideration payable by the Devco as well as the payment mechanism; and
 - outlined the terms and conditions on which the Devco had the right to develop on Propco's land for its own account and risk.

- The Devco secured the acquired rights by registration of a development lease that is:
 - a 99-year lease.
 - registered in the Deeds Office in the form of a notarial deed against the title of ownership by the Propco (Lessor) in favour of Devco;
 - confers a real right to the Lessee, the undisturbed use and enjoyment of the property let to the Lessee;
 - can be used by the Lessee at any time to enforce its real right against the Lessor and all the Lessors' successors in title in the ownership of the property; and
 - allows the bank to register a mortgage bond over the notarial lease to secure any financing of the consideration paid by the Devco for the rights.

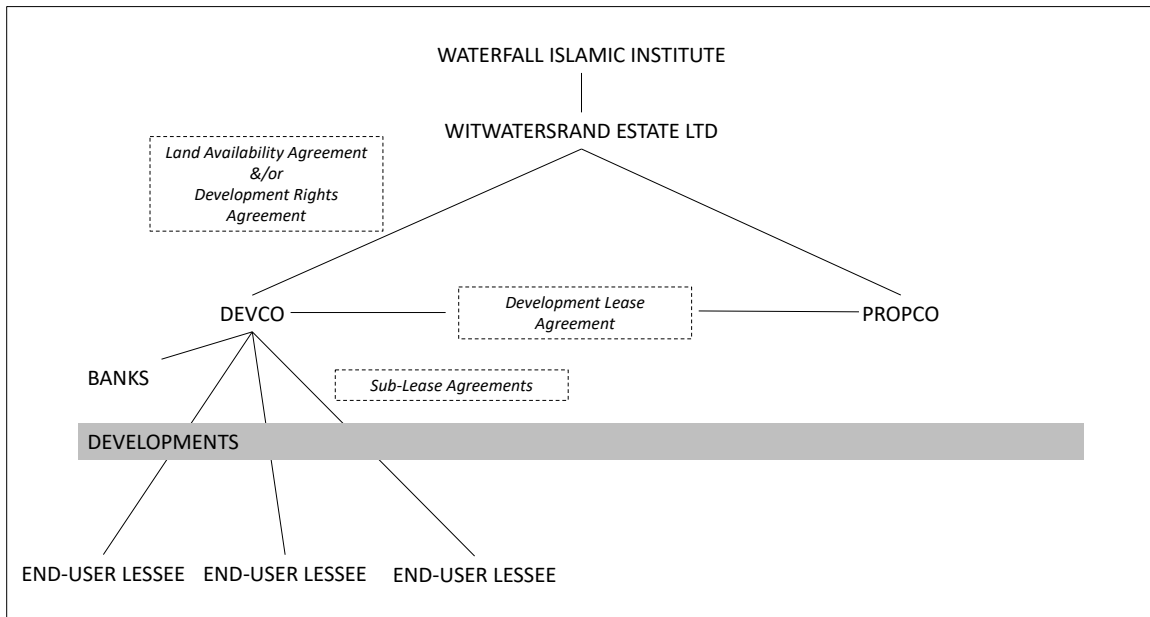
- Through this process the Devco develops and markets the properties.

The Waterfall Estate Development includes commercial and residential developments that have specific structures and agreements, which will be outlined below.

5.1. Commercial Developments

Figure 1 reflects the structure and cascading agreements applicable to commercial developments in the Waterfall Estate development.

Figure 1. Commercial Development Structure



- The development rights included the right to develop the necessary infrastructure and have townships proclaimed in respect of the land to be developed.
- On commencement of any development, the Devco is entitled to call for the granting of leasehold title over the relevant parcel of land.
- This development lease is granted for 99 years and is registered against the title deed. Ninety-nine years is the chosen period for the lease to keep it as closely as possible to full ownership as these developments require enormous commitments and capital outlays for infrastructure and construction of the Devco.
- The Devco then sub-lets the development to various tenants.
- Each lease includes, or will include, an obligation on Devco (or its nominee) to pay monthly rental to the Propco from the date on which it commences receiving rental in respect of the commercial development on the relevant parcel of land.
- The rental to be paid is an amount equal to 6% of the “net rental” received from the tenants. Net rental is defined as gross rental received from tenants (excluding

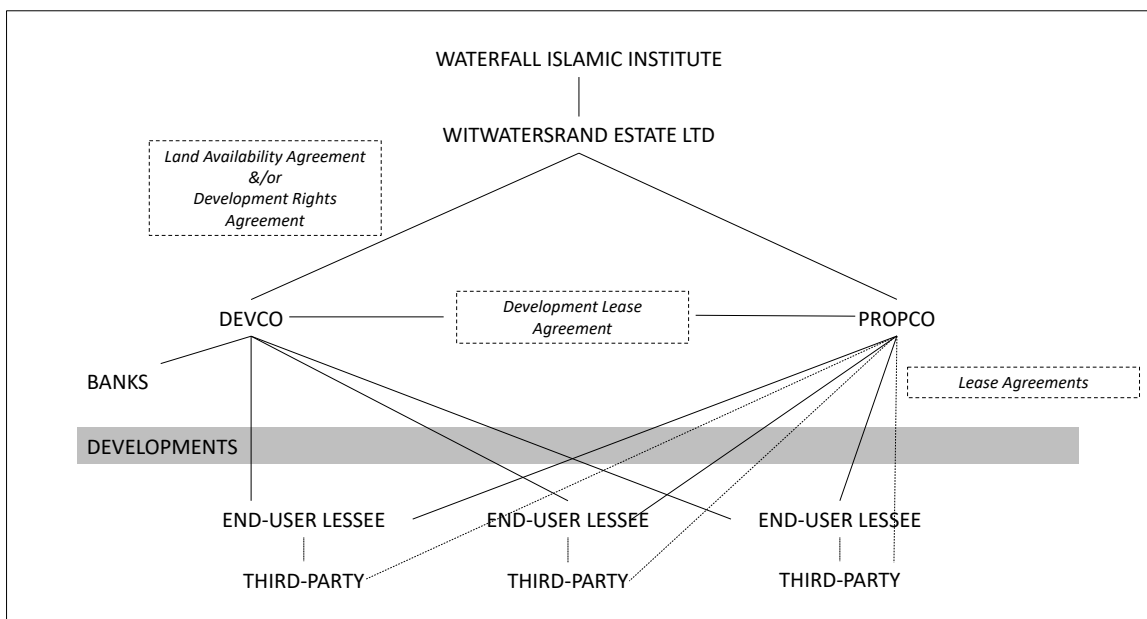
deposits, VAT, municipal charges and tenant installation reimbursements) less 25% in the case of shopping centres and 20% in any other case for operating costs.

- In terms of the long-term leases, the Devco bear the responsibility for payment of all rates, taxes and levies, municipal services, refuse removal and all other relevant service contributions payable in respect of the Waterfall land parcels.
- The development agreements and lease agreements contain typical commercial terms, including any breach and dispute resolutions.

5.2. Residential Developments

Figure 2 reflects the structure and cascading agreements used for residential developments in the Waterfall Estate development.

Figure 2. Residential Development Structure



5.2.1. Development of the Property

- Devco may erect improvements on the property and will, in that event, be entitled to procure the registration of 99-year notarial leases in respect of the individual stands within the township or units within the sectional title scheme.

5.2.2. Sale of Individual Residential Units by the Devco to End-user Lessees

- A purchaser (e.g. “home buyer”), hereinafter referred to as the “End-user Lessee” enters into a sale agreement with Devco in terms of which the End-user Lessee buys the right to occupy the stand/unit for a 99-year period and extensions as prescribed in the agreement of lease.
- On completion and sale of right to occupy the stand or unit, Devco is entitled to call on the Propco to conclude a 99-year lease direct with the End-user Lessee against cancellation of the Devco’s lease (development lease) over the relevant stand/unit or to, with the consent of Propco, cede and assign its 99-year rights to the purchaser.
- The registration of the release of the applicable stand/unit lease from the development lease is registered simultaneously with the registration of the End-user Lessee lease.
- In terms of the development lease agreement, Propco agrees that the payment of the purchase price (lease consideration) by the End-user Lessee, can be paid to the Devco in settlement of the development costs (including profit) of the stand/unit including (but not limited to) the costs of construction and any rentals pre-paid by the Devco to Propco on behalf of the End-user Lessee.
- The duration of the lease is 99 years commencing on the date of registration of the lease with infinite number of extensions restoring the lease to 99 years.
- The extension is subject to payment to Propco of the extension consideration of 3% plus VAT calculated on the fair value of the leasehold title or on the gross disposal price, whichever is the greater (in case of disposal). The extension of the lease will also be notarial registered in the Deeds Office.
- The lease agreement acknowledges that sub-leasing may be applicable, but this is governed in the rules as applicable to the development and determined and amended from time to time by the residents’ home-owners association.
- In discussion, it became apparent that it took some time for the sales staff of the developers, the End-user Lessees and the banks to become comfortable with the new concept of the buyer not owning his unit or stand (on which he has or will build his house) but having a leasehold right. To keep it as closely as possible to ownership, 99 years was the chosen period for the lease with extensions every time for another 99 years.

5.2.3. Sale of Individual Residential Units by End-user Lessees to Third Parties

- The End-user Lessee can dispose of the leasehold title to a Third Party during the lease period, privately, or through an agent.
- If an agent is used, the End-user Lessee needs to select the agent from a panel appointed by the Propco or its nominee. Propco shall procure that commission payable to the agent will not exceed 5% plus VAT thereon.
- On disposal, the End-user Lessee shall, over and above the 3% plus VAT extension consideration, pay 0.5% plus VAT of the greater of the disposal price or fair value of the leasehold title to the residents' homeowners association for the credit of the levy stabilization fund.
- The agreement of sale will grant to the Third Party, against payment of the lease consideration, a 99-year lease subject to the terms of conditions of the agreement of sale and the terms and conditions set out in the lease agreement.
- Once the conditions of the agreement of sale have been complied with, the Propco will sign the notarial deed of extension of the lease term to 99 years and the assignment and cession of the lease agreement by the End-user Lessee to the Third Party.
- A notarial copy of the lease agreement shall be attached to the notarial deed of cession and assignment, which will be registered in the Deeds Office. With effect from the date of registration of the notarial deed of cession and assignment, the End-user Lessee (the Cedent) shall have no further obligations to Propco and the Third Party (as cessionary) shall be the new registered holder of the leasehold title subject to the terms and conditions of the lease agreement.
- Alternatively, the lease agreement between the End-user Lessee and Propco is cancelled and a new lease agreement is entered into between the Propco and the Third Party.

5.2.4. Specific Lease Clauses in Favour of Spouses, Heirs and Banks

- No extension consideration shall be payable if the leasehold title of End-user Lessee is transferred to the spouse in terms of a divorce order or to an heir in event of death. Spouse and heir will take ownership of the balance of the remaining years on the original lease.

- Provisions relating to the distressed disposal of the leasehold title, meaning a disposal by a liquidator or trustee on insolvency of the sub-lessee, or disposal to a Third Party by End-user Lessee where, notwithstanding that the proceeds of such disposal are insufficient to discharge the bank's loan, the bank consents to the said disposal.
- The step-in-rights in favour of the bank. As the lease constitutes the mortgaged property and by reason of breach of conditions of the lease agreement, the lease may be terminated, and the mortgaged property may disappear, the bank must be given notice to be able to step in including being permitted to secure a new lease from Propco on the same terms and conditions as were incorporated in the terminated lease.

5.3. Accounting Treatment

As regard to the Lessee's accounting treatment, IFRS 16 has introduced a single lessee accounting model and requires a lessee to recognise assets and liabilities for all leases with a term of more than 12 months. The asset represents its right-of-use of the underlying leased asset and the corresponding liability its obligation to make lease payments. IFRS 16 is only effective for annual periods beginning on or after 1st of January 2019 but earlier application is permitted.

The previous accounting model for leases required lessees and lessors to classify their leases as either finance leases or operating leases and account for those two types of leases differently. It did not require lessees to recognise assets and liabilities arising from operating lease. IFRS16 requires lessees to recognise assets and liabilities for all leases (with limited exceptions) and gives detail as to the measurement of lease liabilities.

The long-term leases as in the Waterfall Estate development are classified as finance leases as the lessee assumes substantial risk and reward. IFRS16 has amended the definition of investment property in *IAS 40 Investment property* to include both, owned investment property and investment property held by a lessee as a right-of-use asset. Investment properties comprise various categories being completed developments, developments under construction and development rights.

The model to determine the fair values of each of these categories differs due to the different nature of each of these categories and are performed by independent valuers. The determination of the underlying development rights value within the Waterfall development is based on the valuation of the underlying lease of the land whereby the lease payments are contingent and determined at a rate of 6% of the net lease income, which in term is calculated with reference to predetermined formulae. The determination of the value is a highly complex matter as acknowledged in the independent auditor's report in Attacq's annual financial statements 2017. This

research report will not further expand on the accounting treatment as professional accountants and valuers are better qualified to do this.

5.4. Waterfall Estate Development Summary

In summary, the leasehold model of the Waterfall Estate development works well. The drafting of the legal agreements and administration are crucial for the successful implementation. The leaseholders of the development land are responsible for the management of the income, assets and infrastructure in respect of their portion. The Waterfall Estate leasehold model is unique in that the agreements provide for extension of lease for an infinite number of times. Each extension restores the lease back to 99 years.

The agreements also provide for assignment and cession of these extended leases to purchasers' subject to payment of a consideration. Subletting for commercial properties is based on standard commercial subletting conditions whereas subletting for residential properties is in term of the estate's regulations. The Waterfall Estate leasehold model provides security similar to the right of full ownership.

6. Municipal Leasehold Legal Framework

This research project evaluates if the current legal framework allows the municipalities to dispose of their public land through leasehold as per the Waterfall Estate leasehold model described above.

6.1. General Regulatory Framework

6.1.1. The Constitution

The Constitution of the Republic of South Africa, 1996 defines the South Africa government structure as national, provincial and local governments. The Constitution of the Republic of South Africa empowered the municipalities to provide a broad range of services in a sustainable manner.

Section 152 (1) of the Constitution lists the objects of local government as:

- *To provide democratic and accountable government for local communities;*
- *To ensure the provisions of services to communities in a sustainable manner;*
- *To promote social and economic development;*
- *To promote safe and healthy environment; and*
- *To encourage the involvement of communities and community organisations in the matters of local government."*

Section 152(2) of the Constitution stipulates that *“the municipality must strive, within its financial and administrative capacity, to achieve the objects set out in subsection (1)”*

The developmental duties of municipalities are specified in section 153(a) of the Constitution and says that a municipality must *“structure and manage its administration and budgeting and planning processes to give priority to the basic needs of the community, and to promote the social and economic development of the community.”*

Section 154 of the Constitution lays the foundation for co-operative government by requiring both national and provincial government to support and strengthen the capacity of municipalities to manage their own affairs, to exercise their powers and to perform their functions. Furthermore, subsection (2) entrenches the need for both national and provincial government to follow a consultative process with respect to the drafting of legislation affecting the status, institution or powers and functions of local government.

Section 156 of the Constitution and the Schedules 4 and 5 deals with the powers and functions of municipalities.

Section 229 of the Constitution deals with the municipal fiscal powers and functions.

6.1.2. The Municipal Structures Act of 1998

Municipalities were established in accordance with Chapter 2 of the Municipal Structures Act of 1998. They have the right to govern, on their own initiative, the local government affairs of their community subject to national and provincial legislation.

The Municipal Structures Act of 1998 also deals with the powers and functions of municipalities to achieve integrated, sustainable and equitable social and economic development of its areas.

6.1.3. The Municipal Systems Act of 2000

The Municipal Systems Act of 2000 gives the municipalities the right to do anything reasonably necessary for, or incidental to, the effective performance of its functions and the exercise of its powers.

6.2. The Legislative Framework for Leasing Municipal Property

The legislative framework for the leasing of municipal property is contained and governed in a number of Acts and Regulations.

- The Local Government: Municipal Finance Management, Act 2003, (hereinafter referred to as MFMA)
- The Local Government: Municipal Asset Transfer Regulations, 2008 (hereinafter referred to as MATR)
- Municipal Public-Private Partnership Regulations, 2005 (hereinafter referred to as PPP)
- Municipal Supply Chain Management Regulations, 2005 (hereinafter referred to as SCM)
- Local Government: Municipal Systems Act, 2000
- Preferential Procurement Policy Framework Act ,2000 and Regulations pertaining thereto
- Broad Based Black Economic Empowerment Act,2003 as amended in 2014
- The Municipal Property Rates Act of 2004.

The aforementioned acts and regulations provide the general municipal regulatory framework for property development projects. This research paper will assume that municipalities comply with this regulatory framework and will only highlight the challenges that municipalities may be confronted with should they wish to do leasehold developments on their properties similar to the Waterfall Estate development.

The various acts and regulations allow the municipalities to enter into lease agreements. Municipalities should have a detailed leasing policy. The leasing policy of any municipality should:

- Facilitate equitable access to the municipal properties by applying the content of section 217 of the Constitution of South Africa (which stated that procurement must be in accordance with a system which is fair, equitable, transparent, competitive and cost-effective)
- Enable lease transactions and leases to be processed in a legislatively compliant yet efficient manner
- Support the municipal's social and environmental agenda by making provision for the community to be granted access to municipal properties leases at affordable rates.
- Support the use of municipal property to redress existing spatial inequalities and to provide access to residential opportunities near to employment.
- Support the municipal's growth and development strategy, spatial development framework and other municipal environmental and/or economic strategic plans by facilitating the entering into leases with development impact

- Securing future financial gains for the municipality.

Different legislative regimes apply to different property development projects depending on how they are structured e.g. lease or public private partnership. The legislation and regulations in their present format may, as set out hereafter, present challenges for the parties to enter into leasehold developments on terms and conditions as required by developers, banks, commercial, industrial End-users and residential purchasers of the lease rights as per the Waterfall Estate development case.

7. Application of the Waterfall Estate Leasehold Model on Municipal Land

In general terms, the application of the Waterfall Estate leasehold model on municipal land would look as follows:

7.1. The Parties Involved

- The municipality as the owner of the land (the municipality) would enter into land availability agreements and/or development rights agreements in respect of municipal land (the Property).
- A ring-fenced municipal entity (Propco) which would take transfer of the property on which the development would take place. It should be noted that a municipality would not be obliged to create a Propco but may choose to do so, especially for large developments, for logistic and administrative reasons.
- The ring-fenced entity would not be allowed to borrow, sign sureties or provide guarantees, register bonds over the property, sell the property or change its shareholding. It would however be able to comply with the relevant terms and conditions of the land availability agreements and/or development rights agreement and to enter into 99-year leases (the Development Lease Agreement) on the property.
- An experienced private party developer (Devco) would be granted the right to use, control, develop and manage the property in accordance with the municipality's disposal management system and would enter into a 99-year notarial lease with the Propco.
- End-user lessees (End-user Lessees) who may be the end-purchasers of the rights in the 99-year lease or sub-tenants of the commercial stands.

7.2. The Leasehold Model

- The municipality would enter into a land availability agreement and/or development rights agreement (DRA) with a Devco to develop the property.
- The agreements will stipulate the consideration payable by the Devco as well as the payment mechanism, timelines related to the completion of the development, the responsibilities of each party in relation to, inter alia, the township establishment, zoning, services etc.
- Devco would develop the property at its own risk and costs.
- The municipality would transfer the property which is the subject of the development into a Propco.
- Devco's rights in terms of the DRA would be secured by a development lease agreement, which the Devco would enter into with the Propco.
- The development lease is for a period of 99 years.
- Propco would be entitled to terminate the development lease agreement if the DRA is cancelled or terminated.
- The development lease would be registered against the title deed of the property.
- The Devco would be entitled to mortgage its leasehold title as security for any funding obtained from the bank towards the financing of the acquisition and development costs.
- The municipalities would consider development projects on a 99-year leasehold bases over their land which could include large-scale mixed-use including retail, commercial, industrial and residential, to be developed over multi-years. The 99 year duration of the leases in respect of residential appears to be the preferred period as End-user Lessees want the lease rights to be as close as possible to freehold ownership. The duration of the leases related to commercial developments may, in certain cases, be shortened to 40 or 60 years, but this shall depend on the capital input required from Devco. Considerations will also be given to the economic lifecycle of the subject property.

7.3. Commercial Developments

- If the Devco sub-lets the property to End-user Lessees, Devco would pay an agreed percentage of the net rental received from the End-user Lessees. Net rental would be the gross rental received by Devco from the End-user Lessees less an agreed percentage (depending on the property use) for operating costs.
- In terms of these sub-leases, Devco transfers all or part of the right of use of the property for a portion of the unexpired term of the lease or for the same term, but for materially different rent or upon some different terms and conditions.
- The period of the End-user lease agreements in the development of the commercial portions varies from 3 to 99 years. Many are triple nett leases. The financing of these developments is mainly dependent on the cash flow and serviceability from the End-user Lessees (subject to the aforementioned rental considerations to Propco).
- If the improvements on the relevant stands are not sub-let to End-user Lessees, Devco would pay an agreed percentage of the fair market value of rental in respect of stands in the same vicinity and which have improvements of a similar nature as those erected or to be erected on the property.
- The corporate banks providing finance to Devco will assess any development proposal on a case by case basis assessing financial strength of developer, feasibility of the development, valuation, professional team, pre-lets, together with added risk related to ownership by Propco.
- The banks will ensure that their interest is protected as stated above.

7.4. Residential Developments

- The Propco and Devco would enter into 99-year notarial leases in respect of the applicable individual stand within the township, or units within a sectional title scheme.
- The Devco would be responsible for the marketing of the stands/ construction and marketing of the units, to End-user Lessees.
- Devco would be entitled to, subject to receiving the consent of Propco, to cede and assign its rights under the applicable Stand Lease to the End-user Lessee or alternately, Devco may procure the conclusion of a direct lease agreement between Propco and the End-user Lessee.

- The registration of the release of the applicable stand from the development lease would be registered simultaneously with the registration of a stand lease or unit lease in favour of the End-user Lessee.
- Devco would be entitled to receive the disposal consideration.
- The lease may be extended by the End-user Lessee for a further 99 years at any time upon payment to Propco of an amount equal to an agreed percentage of the fair value of the leasehold title.
- In addition, upon disposal of the leasehold title, the lease term would be reinstated to 99 years from date of registration of the deed of extension upon payment by the lessee to Propco of an amount equal to an agreed percentage of the greater of the fair value of the leasehold title or the disposal price. The End-user Lessee would also pay an agreed percentage to the applicable residents' home-owners association for the credit of their levy stabilisation fund.

The notarial deed of lease between Propco and the End-user Lessee, which would be registered against the title deed of the residential property, would include inter alia the following:

- the lease would be subject to all terms and conditions of the lease agreement together with the conditions contained in the title deed of the relevant property, the applicable town planning scheme and/or the relevant diagram or general plan and the rules and regulations set by residents' home-owners associations;
- the End-user Lessee would conclude an agreement with the Devco in terms of which the End-user Lessee would agree to pay the lease consideration to the Devco subject to the Devco procuring the conclusion of the lease agreement with Propco;
- propco would agree with the Devco to let the property to the End-user Lessee who wishes to rent the same from Propco;
- the agreement of lease would make the End-user Lessee responsible for payment of rates, taxes, service charges, levies and any other charges payable in respect of the property (including any such charges or taxes that may, now or in the future, be payable by Propco by virtue of its' ownership of the property);
- in terms of the lease agreement the End-user Lessee would be assured of the legal entitlement to enforce undisturbed right of use and enjoyment of the property. Any permanent improvements to the property would become part of the property owned by Propco but subject to the right of use by the End-user

Lessee however without any right to claim compensation in respect of alteration from Propco;

- propco would agree that the End-user Lessee may register a mortgage bond over the leasehold title (if required);
- to protect the interest of the bank in the event of a default by the End-user Lessee of its obligations to the bank in terms of the loan agreement or mortgage bond, and to make the mortgage bond effective security for the indebtedness from time to time of the End-user-Lessee to the bank, Propco (the lessor) would agree to grant to the bank, rights and benefits in the nature of a stipulatio alteri;
- the registration of the mortgage bond by the bank would be deemed to be acceptance of such rights and benefits by the bank. No bank will consider financing without protecting its interest;
- minor differences may exist in the requirements of the banks depending on the bank's policy/product and/or the nature of the development. Retail banks will assess the risk of financing these leasehold developments based on financial risk of the Propco, Devco and the End-user Lessee. They will limit their exposure to the whole development and to the End-user Lessee;
- at the same time banks would need economies of scale to justify new banking products. They may even consider packaging these loans on leasehold property for securitisation in the future. The use of standard lease agreements for these developments is crucial;
- duration of the lease would be 99-years commencing on date of registration of the Lease with infinite number of extensions restoring the lease to 99 years. The extension would be subject to payment of the extension consideration based on an agreed percentage plus VAT calculated on the fair value of the leasehold title or on the gross disposal price or the fair value of the leasehold title, whichever is the greater (in case of disposal). The extension of the lease will also be notarial registered in the Deeds Office;
- as the End-user Lessee, who has the right of use and enjoyment of the property for the period of the lease, would be entitled, and may be obliged, to erect buildings on the property which become the property of the Propco at the end of the lease, it is crucial that the terms and conditions for extension are agreed to. Unless the End-user Lessee is in breach of the terms and conditions of the lease agreement including the payment of the extension consideration, the lease will be extended for a period equal to the period required to reinstate the lease term to 99 years;

- the End-user Lessee would be able to dispose of the leasehold title to a Third Party during the lease period, privately or through an agent. If an agent is used, the End-user Lessee needs to select the agent from a panel appointed by the Propco or its nominee;
- propco would procure that commission payable to the agent will be an agreed percentage. It is important for all parties involved that the concept of leasehold title is clearly understood by all and that agreed standard documents and lease agreements are used for all stands/units in the development;
- over and above the extension consideration, the End-user Lessee would pay 0.5% plus VAT (or any other agreed percentage) of the gross disposal price or fair value of the leasehold title to the residents' home-owners association for the credit of the levy stabilization fund;
- if all terms and conditions related to disposal have been complied with, Propco would sign the notarial deed of extension of the lease in terms whereof Propco would consent to the extension of the lease term to 99 years and the assignment of the lease agreement by the End-user Lessee to the Third Party. The assignment of the lease would transfer the End-user Lessee's entire interest in the lease without material alterations or addition to the terms of the lease and without the End-user Lessee retaining any reversionary interest in the lease. With effect from the date of registration of the notarial deed of cession and assignment, the End-user Lessee (the cedent) would have no further obligations to Propco and the Third Party (as cessionary) would be the new registered holder of the leasehold title subject to the terms and conditions of the lease agreement;
- alternatively, Devco may procure the conclusion of a direct lease agreement between Propco and the End-user Lessee.
- no extension consideration would be payable if leasehold title of the End-user Lessee is transferred to the spouse in terms of a divorce order or to an heir in event of death. Spouse and heir would take ownership of the balance of the remaining years on the original lease;
- provisions related to distressed disposal of the leasehold title, meaning a disposal by a liquidator or trustee on insolvency of the sub-lessee, or disposal to the Third Party by End-user Lessee where, notwithstanding that the proceeds of such disposal are insufficient to discharge the bank's loan, the bank would consent to the said disposal. In the Waterfall Estate development arrangements were made with the banks to ensure that Propco would receive a minimal payment from the bank when the proceeds of the disposal were insufficient to defray the indebtedness of the End-user Lessee to the bank. These

arrangements will always be subject to negotiation. The agreed terms must be included in the standard agreements for the relevant development. It is advisable to have a limited panel of attorneys that provides professional advice on the leasehold structure and all documentation related thereto. All terms and conditions and documents must be finalised on a case by case basis;

- provisions related to forced disposal of the leasehold title, meaning disposal to a Third Party following a sale in execution pursuant to a default by the End-user lessee under the bank's loan or mortgage or where the bank (or its nominee) has bought in the leasehold title at the sale in execution;
- standard clauses related to possession, occupation, insurance, resident associations, expropriation;
- breach and cancellation clauses;
- warranties and limitation of liability of Propco, its directors or agents;
- general standard clauses related to agreements of lease; and
- restriction against cancellation, to protect the End-user Lessee and the bank. When the bank considers financing developments on leasehold basis for the Devco and End-user Lessees, it not only evaluates the experience and delivery risk related to the Devco, the property, the financial strength of the Devco and/or End-user Lessee but also the risk related to Propco. The ring-fencing of Propco to protect the End-user Lessee and the bank. As Propco would be a municipal entity, the bank would assess the municipality for financial and operational risk.

8. Legal Considerations Regarding the Use of the Waterfall Estate Model to Develop Municipal Land

The municipal legal framework applicable in respect of a development based on the Waterfall Estate leasehold model will vary depending on whether the development falls within the ambit of the Municipal Asset Transfer Regulations or the Municipal Public-Private Partnership Regulations. A municipality has no discretion to choose between the two but must comply with Public-Private Partnership regulations if a development meets the requirements of a PPP.

8.1. Municipal Asset Transfer Regulations (MATR)

Chapter 4 of the MATR governs the granting of a right to use, control or manage municipal property (through lease or land availability agreement or other development agreement) that fall short of outright sale or permanent disposal. The provisions of

Chapter 4, do not apply to PPPs or the granting of rights on municipal land to housing for the poor beneficiaries (Regulation 33(2)(a) & (b)). However, Regulation 33(3) of MATR provides that the right to use, control or manage municipal property must be dealt with as a transfer under Chapter 2 or 3 of the MATR (relating to transfer and permanent disposal) even though it does not constitute a 'transfer', as defined in the Regulations, if the right:

- (a) *Is granted for an indefinite or undetermined period;*
- (b) *Is granted for a period which exceeds the useful life of the capital asset or the economic usefulness of the capital asset and would require the asset, in order to remain economically useful, to be substantially upgraded, altered or replaced during the period for which the right is granted; or*
- (c) *Confers on the person to whom the right is granted an option to buy or acquire ownership in the capital asset; or the power to use, control or manage the capital asset as if that person is the beneficial (but not legal) owner of the asset.*

When the municipality enters into 99-year leases in respect of its properties, 33(3) as per above may well therefore be applicable.

In terms of regulation 34 of the MATR, the council of a municipality may grant an in-principle approval to grant rights to use, control or manage a municipal property. The in-principal approval by the municipality to grant rights to use, control and manage municipal property may include specifications as to the type of development, period for development and expected compensation for the municipality.

For high value transactions and where rights will be granted for more than 3 years, a public participation process must be done before council can approve in principle the granting of the rights. The granting of these rights must be fair, equitable, transparent, competitive, cost effective and consistent with the municipal policy or regulations. By virtue of the core principles, as a general rule, whenever these rights are granted, a competitive process must be followed. The municipality is required to follow the provisions of the municipal policy and the relevant regulations included in Part 1 of Chapter 4 of the MATR. Methods of awarding leases may be by bidding process either by public tender or auction or by unsolicited bids or under certain conditions by private treaty.

In terms of the existing legislation and regulations, municipalities can enter into development rights agreements as long as they do so within the ambit of the processes and procedures as prescribed in the SCM regulations, municipality disposal management system and municipal policy.

The municipalities can also enter into long term lease agreements in respect of parcels of municipal land. The entering into these development rights agreements and lease agreements with a Devco as described above may offer municipalities a better

combination of cost, quality, quantity, productivity, risk and leverage capacity of financial resources, then could otherwise be obtained.

A Devco would never be party to any development that it does not deem commercially viable, as it needs to maintain a healthy and profitable company for the development to succeed and deliver value. The municipality can only benefit from this success over a long period while still retaining ownership of its property.

Regulation 45 of MATR, in particular deals with the agreements granting rights to use, control or manage municipal capital assets. Subsection 45 (2)(a) and (b) set out ten minimum terms and conditions which need to be included in the agreements on which the rights are granted. These conditions are easily complied with save for the tenth condition:

“(x) a clause disallowing the private sector party or organ of state to whom the right is granted from ceding or subcontracting the right to another person.”

This condition creates a problem for the Devco, the banks and the End-user Lessees (purchasers) in developments based on the Waterfall Estate Model.

For the Devco:

- Devco may, for commercial reasons or risk related reasons, want to transfer his lease rights to a subsidiary or related party or a Third Party through a deed of cession and assignment.
- Devco needs to be able to enter into agreements with sub tenants. Additionally, Devco needs to be able to enter into deeds of cession and assignment in respect of the rights in the 99-year lease with the End-user Lessee (purchaser).

For the bank:

- The bank would insist on step-in-rights in the event of default of the Devco, as the tenant but also in the event of breach in terms of the DRA.
- The bank’s mortgage bond with the Devco would include a cession of the income received by the Devco from the sub-tenants as security for the repayment of the bank’s loan to the Devco.
- The bank’s mortgage bond to the End-user Lessee (purchaser) would include step-in-rights as well as cession of any income from sub-tenants if applicable.

For the End-user Lessee:

- The End-user Lessee (purchaser) may require a loan from the bank for the acquisition of the stand or unit. As the bank would also, in this case, register a

mortgage bond over the rights in the lease agreement, the mortgage bond would again include step in rights in favour of the bank.

- The End-user Lessee may want to sub-let its commercial or residential unit or portion thereof. If finance is in place for the End-user Lessee, the mortgage bond will also include a cession of income from the sub-lease.

8.2. Municipal Public-Private Partnership Regulations (PPP)

If the development is a Public-Private Partnership transaction, then the PPP regulations will apply and not the MATR. The PPPs for municipalities are governed by the MFMA and PPP regulations and, in cases involving municipal services, the MSA. Every PPP project is to be structured on a combination of financial, technical and BEE components (in compliance with the Preferential Procurement Policy Framework Act of 2000 (PPPFA) to achieve optimal value for money in government's delivery of infrastructure and services.

A PPP is defined in the regulations as:

“..a commercial transaction between a municipality and a private party in terms of which the private party –

- (a) Performs a municipal function for or on behalf of a municipality, or acquired the management or use of municipal property for its own commercial purposes, or both performs a municipal function for or on behalf of a municipality and acquires the management or use of municipal property for its own commercial purposes; and*
- (b) Assumes substantial financial, technical and operational risks in connection with:*
 - i. The performance of the municipal function;*
 - ii. The management or use of the municipal property; or*
 - iii. Both; and*
- (c) Receives a benefit from performing the municipal function or from utilising the municipal property or from both, by way of –*
 - i. Consideration to be paid or given by the municipality or a municipal entity under the sole or shared control of the municipality;*
 - ii. Charges or fees to be collected by the private party from users or customers of a service provided to them; or*
 - iii. A combination of the benefits referred to in subparagraphs (i) and (ii)”*

A municipality could identify as part of its' municipal Integrated Development Plan (IDP) that municipal property could be used by the private sector for its own commercial use and that requires private sector finance and skills for its development. A pre-feasibility study should identify any regulatory provisions that may impact on the proposed PPP project as well as the potential revenues that could be generated by the municipality and socio-economic impact of the proposed PPP project. If National Treasury

determines that the project is indeed a potential PPP for private sector commercial use of municipal property, the proposed project will be registered with the PPP Unit who will appoint a project advisor, where after a feasibility study in terms of Section 120(4) of the MFMA will be undertaken.

The total cost to the municipality of the procurement of the proposed PPP project may result in additional costs to the municipality, like costs for additional resources (transaction advisor, project officer) to procure and manage the PPP.

The PPP project identification normally forms part of the municipality's integrated development plan (IDP) and must describe the nature and size of the activity, the current municipal budget, projected development costs and an initial list of risks.

In the case of a PPP involving the use of municipal property for commercial purposes by a private party, value-for-money is demonstrated by the extent to which the project will meet the municipality's objectives for the use of that property. The objectives may include:

- 1) Increased direct revenue to the municipality
- 2) Increased socio-economic activities within the community
- 3) Optimal use of under-performing assets
- 4) Job creation
- 5) BEE

The PPP agreement must comply with certain basic requirements including provisions to ensure effective monitoring of the contract, transparent financial management by the private partner and compliance with section 33 of the MFMA (contracts having future budgetary implications). The PPP agreement can only be amended after a public participation process has been conducted and the reasons for the amendments have been tabled in the municipal council and provided that the views of National and Provincial Treasury have been solicited at least 60 days before the agreement is amended.

Although a development based on the Waterfall Estate leasehold model could be legally structured as a PPP (when rentals collected in terms of lease agreement are drafted in way to comply with (c) (ii) of the definition of PPP)², the practical feasibility of implementing such a development within this rigid structure is questionable. The long lead times to get to an approved DRA/partnership contract, the long amendment process and limited flexibility will make it very difficult to find a private party willing to

² There some debate as to whether lease income earned by a Devco would constitute a "charge or fee" as per c (ii) in the PPP definition. As a result, if a PPP is not deemed the preferred structure then it may be advisable to draft the lease agreements in such a manner that any rentals received by the Devco reflect payment for the top-structure and/or services provided by the Devco and not the municipal land.

take the risk to enter into a PPP on leasehold land with the municipality. The feasibility of a development is influenced by conditions in the macro-economy and the position of the property cycle. Construction costs are the highest cost item in any development. The private partner/developer cannot afford to have a delayed start of the project due to a long lead time for council meetings and National Treasury approvals, nor does he/she want to be exposed to political risk. It became apparent in discussions that municipalities and the private sector perceive the PPP legislation with its limited flexibility to tailor transaction to market conditions too constraining.

8.3. Municipal Finance Management Act (MFMA)

Sound financial management practices are essential to long-term sustainability of municipalities. The key objectives of the Municipal Finance Management Act 2003 were to ensure that through its four components (planning and budgeting, revenue and expenditure management, reporting and oversight) municipal expenditure would be developmental, effective and efficient and that municipalities are held accountable.

Section 14 (5) deals with the process of disposal of state assets. It states:

“Any transfer of ownership of a capital asset in terms of subsection (2) or (4) must be fair, equitable, transparent, competitive and consistent with the supply chain management policy which the municipality must have and maintain in terms of section 111.”

Section 164 (1) (a) of MFMA deals with forbidden activities. It states:

“ 164 (1) No municipality or municipal entity may:

- (a) Conduct any commercial activities (i) otherwise than in the exercise of the powers and functions assigned to it in terms of the Constitution or National or Provincial legislation or (ii) outside the borders of the Republic.”*

The question is whether Section 164 (1) (a) would be applicable to agreements to be entered into by the municipality or Propco in applying the Waterfall leasehold model on municipal land.

9. Summary of the Legal Considerations Applicable to the Case (non-PPP)

Should a non-PPP process be followed, then the following legal issues are likely to arise:

9.1. Development Lease Between Propco and Devco

Based on the above, due to their long-term nature, it is likely that the development lease agreements entered into between the Propco (Municipality) and the Devco would be deemed as a sale. This would have the following implications:

- Regulation 45 of the MATR would not apply and the issues outlined above pertaining to the restriction on sub-letting and cession of leases would be avoided.
- However, Chapter 2 of the MATR would apply and any agreement would be subject to Section 14 of the MFMA requiring that any disposal follow a fair, equitable, transparent and competitive process. This should not present a hurdle with respect to agreements entered into with a Devco as this is likely to be a once off or limited number of events.

9.2. End-user Lessee Purchase Agreements

Based on the above, due to their long-term nature, it is likely that the development lease agreements entered into between the Propco (Municipality) and the End-lessee would be deemed as a sale. This would have the following implications:

- Regulation 45 of the MATR would not apply and the issues outlined above pertaining to the restriction on sub-letting and cession of leases would be avoided.
- However, Chapter 2 of the MATR would apply and any agreement would be subject to Section 14 of the MFMA requiring that any disposal follow a fair, equitable, transparent and competitive process. As there are likely to be multiple and repeat agreements, this requirement is likely to be highly problematic from a practical and administrative perspective and is likely to be a severe disincentive to End-user Lessees entering into such agreements in the first place.

9.3. Shorter-Term Commercial Lease Agreements

Based on the above, Chapter 4 of the MATR may apply. This would have the following implications:

- Regulation 45 of the MATR would apply and the issues outlined above pertaining to the restriction on sub-letting and cession of leases would be applicable.

10. Legal Amendments or Actions Required

It is clear that developments like the Waterfall Estate development can be done on municipal leasehold land. Municipalities would benefit when entering in master development agreements with developers who would have the expertise, experience and financial means to fully develop the property. The developments could be phased to unlock confidence and create value as well as unlocking different funding sources. Through a leasehold structure an ongoing income stream would be created for the municipalities. It became apparent that municipalities and the private sector perceive the PPP-legislation with its limited flexibility to tailor transactions to market conditions too constraining. The legal framework to best facilitate these municipal leasehold developments would fall within the ambit of the Municipal Asset Transfer Regulations. However, the following would need to be addressed to allow for this framework to be used:

10.1. Municipal Asset Transfer Regulation 45 (2) (x)

With respect the lease agreements between the Devco and shorter-term commercial tenants, this regulation disallowing the lease right holder from ceding or subcontracting the right to another person needs to be amended to facilitate these developments.

A full deletion of the condition is not required as it gives important protection. However, in specified cases, like leasehold property developments on the Waterfall Estate model, cession and subcontracting should be allowed. There are various options as to how to create this deviation. The exception can be allowed by amending the regulations or by adding it as an exemption as per Regulations 50 of MATR or by application to National Treasury for a departure on case by case basis in terms of Section 170 of MFMA or to permit it subject to municipal approval. The latter, may be the more feasible option. However, it should be considered that the required deviation as discussed above should be subject to the following condition.

10.2. Municipal Finance Management Act Section 14

With respect to the purchase agreements between the End-user Lessees and the Devco, Section 14 of the MFMA requiring that any disposal follow a fair, equitable,

transparent and competitive process would also need to be addressed through a departure from the requirement.

10.3. Municipal Finance Management Act Section 164 (1) (a)

The term 'commercial activities' is not defined in Section 164 (1) (a) of MFMA, which makes the scope of this prohibition quite wide. Leasing of property can be seen as a commercial activity. However, legislation and regulations allow municipalities and its entities to enter into development agreements and lease agreements within the constraints of the general municipal framework as detailed earlier in the paper. In addition, it can be argued that, as the costs, risk and the responsibility for the infrastructure, construction, management of the income, and marketing of the property/stands/units in the Waterfall Leasehold model vest with the Devco, the commercial activity lies with Devco and its related companies. Neither the municipality nor Propco take any operational or marketing risk.

However, even if it were deemed a commercial activity, it could still be argued to be permissible as an activity done in the exercise of the municipality's powers and functions as property owner. Similarly, Section 164 could be interpreted as permitting commercial activity, as long as it is not its powers and functions or outside South Africa.

Notwithstanding this, it is recommended that when municipalities want to proceed with developments based on the Waterfall Estate leasehold model, they obtain clarity guidance from National Treasury regarding the application of Section 164 (1)(a).

11. Conclusion

Municipalities have an important role to play in fulfilling the socio-economic development of the country. But this role is not limited to projects with direct socio-economic public outcomes but also includes revenue generating projects where municipalities can use their property to benefit from income-yielding assets and ongoing income streams. The projects may also be a combination of both.

Municipalities should therefore adopt a holistic approach to the management of their properties that gives due regard to the following principles:

- 1) The best interests of the municipal local community
- 2) The best and optimal utilisation of a property within the municipality's strategic objectives
- 3) Transparency, accountability and consistency
- 4) The requirement that property transactions are in accordance with a system which is fair, equitable, transparent and competitive
- 5) The use of municipal property to promote social integration, to redress existing spatial inequalities, to promote economic growth, to build strong, integrated and dignified communities and to provide access to housing, services, amenities, transport and employment.

- 6) The management of the municipal property as a sustainable resource by leveraging environmental, social and economic returns while retaining ownership of the property.

Developments based on the Waterfall Estate model would provide the municipality with an ongoing income stream while retaining ownership of the property. As the highest return from a development may not always be achieved in the framework of principle 5 above, fulfilment of this principle could be achieved through the amendment. It is therefore recommended that the amendment of the condition related to the cession and subcontracting not only be subject to approval by the municipality but also to a condition that the municipality may only use the income earned by a Propco for the promotion of the principles as detailed above. As a Propco would be a ring-fenced company this condition could easily be included in its Memorandum of Incorporation. This would make it possible for the municipalities to manage their immovable properties as a sustainable resource by leveraging social, environmental and economic returns, while still retaining ownership thereof. This way they could secure future financial gains and create a practical framework for the managing and letting of developments as per the Waterfall model.