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The ABCs of Ground Leases



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By Steve Bergsman

Although ground leases have become fairly common in retail property transactions, they are still somewhat rare for office and industrial buildings. Since most professionals who belong to the SOCIETY OF INDUSTRIAL AND OFFICE REALTORS® may broker only a handful of ground lease deals over the course of a decade, they tend to have to reinvent the process every time or hand the contract over to a partner who has some experience in ground leases.

Ground lease deals are not very complex, and it is a good tool to have in your repertoire especially in situations where the owner of a property, for one reason or another, just won't sell the land.

Different manifestations of ground leases complicate things a bit, and if you make mistakes in the details, it will be costly to

either the tenant or lessor. But the simple fact is that, if done correctly, ground leases offer considerable advantages to all parties. And, except for length of lease, ground leases tend to play out the same way everywhere in the United States and Canada.

Formally, a lease is a temporary right to use real estate or property in exchange for payment or rent. In a ground lease, the owner of the ground leases the right to use that land to a second party, who is obligated to build a worthwhile structure on it. (What determines "worthwhile" is laid out in the lease documents.) Since the second party owns the structure, the ground lease, in effect, separates the ownership of the land from the building for a set period of time.

Best Case: Creditworthy Tenants Who Don't Want to Buy

As noted, the most common ground lease usually involves retail and that's because the best sites, such as a corner location, are often on land that is not for sale. Also, chain retailers, from McDonald's to CVS, are often not interested in property ownership.

"If you have a good site, retailers will agree to do a ground lease because they can finance building construction through a bank line and they don't need to place a loan against the property," notes **J. Michael Boyd, CRE, SIOR**, 1999 SIOR President, an SIOR course instructor, and Principal of Boyd Commercial, LLC, in Houston, Texas.



The big advantage for retailers, Boyd continues, is that it is an efficient way to get a good site that cannot be bought. Obviously, a second advantage would be that the retailer doesn't have to come up with the \$400,000 or so to buy the land, although from a corporate perspective of the chain retailer that wouldn't be a problem.

For the landowner, the key consideration in granting a ground lease to a national retailer is that the retailer is creditworthy and, as Boyd asserts, the income stream from the lease "is as close to a bond from a security point of view as you can get in a real estate transaction." And, if for some reason, the lessee defaults under the lease and it is not cured by the lessee's lender, the lessor keeps the improvements on the property.

Value of Long Leases; Problems Near the End



The first question that arises in regard to a ground lease is how many years the lease should run. In the United States, leases are generally long-term. "Medium-term would be 55 years, while 75 or 99 years would be long-term," notes **Christopher McGranahan**, Partner and Co-founder of Associate SIOR firm McGranahan Carlson & Co. in Fullerton, California.

The obvious reason for the lengthy term of the ground lease is that if you are making improvements,

i.e., constructing a building on a property, you would like to control that investment for a very long time. However, there is a second reason for the lengthy term: The ground lease can be sold and, banks are willing to finance these deals until there is a relatively short time left on the lease.

R. Scott Martin, SIOR, an office specialist with



NAI Capital in Pasadena, California, came across a medical office building in LaCanada, California, that was on a ground lease. He decided to buy it as an investment. The origination of the ground lease was in 1964 and it is

to run for 99 years. Martin bought the property in 2007, which meant there were 56 years remaining on the lease.

"The first thing lenders look for is the length and terms of the lease," Martin explains. "When the remaining time on the ground lease gets inside 30 years, it can become very difficult to finance."

But some ground leases in the United States are even less than medium-term.

Linford L. Good, CCIM, SIOR, Senior Vice



President of Brokerage Services at High Associates in Lancaster, Pennsylvania, explains that in his area of the country, industrial or office ground leases are uncommon, but he did one for a vehicle leasing firm.

The lessee originally wanted to buy the land, but the owner wasn't selling, so a compromise was set, where the vehicle leasing operator, a national company, would lease the land for 25 years.

The site was nine acres and Good says, the lessee built a "very nice facility" which has since been expanded to about 20,000 square feet of space with a show room, office space, service bays, and a large vehicle wash area.

The landlord needed the lease to be for less than 30 years because in Pennsylvania anything longer would have involved transfer taxes, says Good. "When the lease is up, the vehicle leasing company has the option to renew for two additional five-year periods. In the end, however, the lessee built this gorgeous building and some day will walk away from it."

Canada: Shorter Term Now, Longer in Future?

Common time considerations on ground leases are not the same everywhere. Developers in Ontario, Canada's most populous and industrialized province, generally do not do many ground leases, but when situations come up, the ground lease is written for much shorter periods of time.



"Typically, ground leases in Canada are written for five years with four five-year options, so the land is actually tied up for 25 years," explains **Sydney V. Hamber**, SIOR, a Senior Vice President with DTZ Barnicke in

Burlington, Ontario.

Even if the ground leases are for longer periods, they are not much longer. Hamber recalls that a 35-year ground lease was transacted in an area just west of Burlington where the lessee built a 500,000-square-foot distribution center.

Limitations on the timelines may open up in the future as more ground leases are written in the Ontario markets. "We may see more ground leases

transacted because land prices here have been rising steadily," says Hamber. "Industrial land in some places is going for \$750,000 to a \$1 million an acre and people are saying, 'We can't afford that.' Instead, they're saying, 'We'll give you a five to six percent return on the value of the land and lease it from you long-term.'"

Hamber is putting together a ground lease on a six-acre site in Hamilton, Ontario, where the lessee will be a manufacturing company that needs this particular location because there is a limited amount of land for the zoning they require. The owner of the land will not sell, so the manufacturers will be forced to take a ground lease.

"In the United States, they may be thinking 55 years, but most people here think 20 years," says Hamber.

Avoid Pitfalls: Write Increases into Contract

Ground leases that turn into bad situations usually happen because the broker and attorney advising on the transaction don't account for the consistent appreciating value of the land.

Kevin C. Geenty, SIOR, Vice President of The Geenty Group, REALTORS®, in Branford,



Connecticut, says he was involved in two leases, one for 50 years and the other for 99 years, where the attorneys representing the landowner either failed to write in a single rent increase or did not include high enough percentage rent increases.

"In one case, the landowner, a man who ran a landscape nursery, took half of his retail site and leased it to a developer who was going to build a Class A office building," Geenty says. "When I first saw the draft of the lease, I said to the attorney, 'You need some rent increases here because the value of the real estate is fixed by its income. The value of the property in 98 years won't be worth a penny more than it is today if there are no escalators in the lease.' My advice fell on deaf ears."

That landlord is now 30 years into the lease, says Geenty, "and the value of the

land has not appreciated. If the landlord wants to sell, the value of that land is based on the rental rate or cap rate of the income. It is never going to increase in value as long as it is covered by that lease.”

If you don't write into the ground lease a clause that takes into consideration the escalation of the land value, or conversely, loss of purchasing power of the dollar, then you will find yourself with an undervalued piece of property, says Michael Boyd. “I know of two ground leases, both of which had fixed rents for the primary terms of 40 years. Today the ground is worth conservatively 30 times what it was worth at the time the lease was signed, yet the ground lessee has controlled it at a lower price.”

Boyd reports that his deals are usually done on a 20-year primary with escalations every five years (lately at 10 to 12 percent) and at the end of 20 years there is a re-evaluation of land value on which the new rent level is based. As an example, a landlord has an acre site on a retail corner and it is valued at \$430,000. At a 10 percent return, the lessor pays a rent of \$43,000 a year, but every five years there is an escalation, so the rent jumps 10 percent to \$47,300, to \$51,000 and then to \$56,000. At year 20, the re-evaluation shows the land is now worth \$600,000, so the new rent would be \$60,000 for the next five years.

“If you don't write into the ground lease a clause that takes into consideration the escalation of the land value, . . . you will find yourself with an undervalued piece of property,”

—*J. Michael Boyd, CRE, SIOR*

law firm. “Ground leases are entered into for the purpose of having the tenant make direct improvements on the land, whether it is vacant or there is a building on it that needs to be demolished so something new can be built.”

Think of it as an alternative financing device, Marsh adds. “The landlord receives rent only; the tenant secures financing and builds required improvements.”

Suppose you are a landlord with a piece of land containing dilapidated buildings that you want to demolish and replace with income producing properties, but you don't want to borrow the money to build and

lease out the space. You can transfer all those ownership obligations to a tenant under a long-term ground lease. In this case the lessee will act like an

Trade-Offs: Fewer Obligations for Landlord—More Control for Lessee



Ground leases are typically long-term—greater than the useful life of the improvements that are built on the land, explains Darlene Marsh, Esq., an attorney in the Nashville, Tennessee, office of Associate member firm, Burr & Forman LLP, a regional

owner. “The landlord won’t get as big a cut of the action,” says Marsh, “but it will receive ground rent with a kicker (escalation clause) and these deals are almost always triple-net. The tenant picks up all the taxes, insurance, and operating costs.”

From a landlord’s perspective, the lease should require improvements to be constructed and a level of maintenance on the property that will maintain the value of the improvements.

On the other side of the contract, the lessee will enjoy a great deal of freedom of operation, such as being able to assign or sublet the premises without the landlord’s consent.

“The lessee will also want leeway in the kinds of improvements required to be built,” says Marsh. “If I were representing the tenant, I would much rather agree to a minimum dollar amount (of improvements to the land) than to any limitations on size or configuration, because over 30 years, things will change. As long as you spend the minimum, then the landlord does not have any right to come in and require additional expenditures.”

For the lessees, there are two tax reasons why a ground lease is a good deal: They can take both the depreciation and the interest expense deductions.

Most ground leases require that improvements to the land revert back to the landowners at the end of the lease. On the other hand, the lessee might want to capitalize on the improvements and be given the option at some point in the future to buy the land.

Who Benefits Most from Rising Land Values?



John M. “Mac” Hamilton, CCIM, CPM, SIOR, President of Hamilton Real Estate in Rochester, Minnesota, maintains that ground leases would become more popular if the lessees at some point in the future were given the option of acquiring the property on which they have made improvements.

For example, a manufacturing company may want to save the capital that would normally be needed to buy a property and instead use it to make the business more successful. However, Hamilton adds, that manufacturer “probably doesn’t want to spend \$800,000 on a building then hand it over to the ground owner 50 years in the future without getting any residual value.”

To preserve that residual value, lessees need the opportunity to buy the land, maybe every five years on a 50-year lease, says Hamilton. “At some point, if the neighborhood takes off in value, which has been the case with our developments, then the lessee gets an incredible buy.”

If a neighborhood “takes off” as Hamilton suggests, does the value of

a ground lease increase as well? The short answer is, yes—although ground leases generally trade at a discount to a property that is fee-simple.

Athan Sunderland, SIOR, a Vice President of Preston Partners, Inc. in Columbia, Maryland, has done a number of deals in a submarket of Columbia called Oakland Ridge, which is all subleased land. “This submarket was the first development focused on the business community in the Columbia market, which today is the most sought after location in the Baltimore-Washington Corridor,” Sunderland says.



Since this is such a prized location, a number of institutional investors have acquired properties in Oakland Ridge despite the buildings being on ground leases. “For example, three years ago AMB Property Corp. traded, as part of a large portfolio, one half of its Oakland Ridge assets to RREEF,” says Sunderland.

The ground leases were originally for 99 years and as of 2008, the leases still have 57 years left to go.

Land has become very pricey in Oakland Ridge, as in the rest of Columbia, and if similar plots of land used for business development were to sell in Oakland Ridge and in a nearby location, the ground lease land would sell for a minimum 10 percent discount compared to the fee-simple property. The discount between the two sometimes can go as high as 15 to 20 percent, says Sunderland. “Between 2003 and 2008, the value of fee-simple property rose from \$95 per square foot to \$150 per square foot, while ground lease land jumped from \$70 per square foot to \$135 per square foot.”

The big question, says Sunderland, is what happens to the ground leases in the future. “When you get inside 40 years, somebody will start to raise a red flag and say, ‘Hold on, I will have trouble getting out of this investment because there may not be enough time left on the ground lease,’” says Sunderland. “I anticipate in the next 10 to 15 years the ground leases will become a real issue.”