

# How Ground Leases Create New Opportunities For Long-Term Real Estate Owners

**F** [forbes.com/sites/joshuastein/2024/12/20/how-ground-leases-create-new-opportunities-for-long-term-real-estate-owners](https://forbes.com/sites/joshuastein/2024/12/20/how-ground-leases-create-new-opportunities-for-long-term-real-estate-owners)

Joshua Stein

December 20, 2024



Even ground lease owners who will never sell should plan ahead for a future sale. They should make their ground lease as palatable as possible to future buyers.

getty

Historically, property owners have signed ground leases when they have wanted to convert their property into a secure income stream instead of closing an outright sale. In one of these transactions, the owner ground leases the land to a developer. The developer constructs a building on the land. In exchange for paying rent, the developer has all the benefits and burdens of ownership for the ground lease term. If the developer defaults under the ground lease, it loses its very substantial investment in the building. This assures the owner that such a default is extremely unlikely, at least after the developer has completed construction, and assuming no huge shifts in the market.

Traditionally, for idiosyncratic reasons, for sentimental reasons, or to create an income stream for several generations of a family, property owners that pursued ground leases often believed they would never sell their leased land.

Ground leases can, however, be very attractive even to property owners who are not committed to retaining long-term ownership. These owners realize that, instead of selling outright to a developer, they can often achieve higher sales prices by selling their land subject to a long-term ground lease, a so-called “leased fee,” to a long-term investor. Those transactions have become more popular in recent years.

If an owner wants to sign a ground lease it should carefully consider the requirements of a future buyer, even if the owner does not currently intend to sell. By complying with those requirements, the owner can also help achieve better financing of its interest even if the owner never sells. A future buyer’s requirements are harmless. There is nothing in them that a landowner shouldn’t want.

A market for leased fees has always existed. Conservative long-term real estate investors love the stable, predictable and secure cash flow that a leased fee can deliver. The universe of readily available potential leased fee purchasers has expanded in the last 10 years or so. A few major institutional-quality players have focused on the market and have acquired or created billions of dollars of leased fee assets.

If a ground lease checks all the institutional investor’s boxes, one of these investors may pay a purchase price that significantly exceeds what an owner could expect in a straight-out sale of the undeveloped site to a developer. But the deal really must check all those boxes. Any boxes left unchecked will diminish value or perhaps even prevent a transaction.

Investors of this type typically say they don’t require anything in a ground lease except what’s needed to preserve the security of the cash flow and the value of the asset. They want to know that the ground lease shifts to the tenant all possible risks of the property – past, present, and future – leaving no risks on the owner’s shoulders. If there is any “leakage” of risk, the investor will try to quantify the likely exposure for the owner and discount the purchase price accordingly. If a risk can’t be quantified, the investor might pass.

For example, an owner sometimes agrees to retain responsibility for some elements of the leased premises or may agree, for example, to pay some share of maintenance costs, real estate taxes above some base, or the cost to repair a retaining wall if it breaks. That may all seem “fair and reasonable,” but it creates a problem for value of the leased fee, because all the investor will ever get is the agreed rent stream, and no meaningful upside of the asset. If the owner has any responsibilities, that dilutes projected cash flow and creates uncertainty, which often leads to a discount in the purchase price for a leased fee. An investor will

particularly worry if the owner retains any responsibility for historical environmental conditions – again, something some people consider “fair and reasonable” but in practice creates a major negative for any future investor in a leased fee.

If an owner keeps any residual responsibility or liability, that means the owner has the risk of unpredictable claims, disputes, and burdens. That’s exactly what a future buyer of a leased fee doesn’t want. A careful ground lease negotiator will figure out a way to avoid all that, or at least severely limit it, perhaps by amount or by time.

In any ground lease, the developer/tenant and its lender will typically pay to develop or redevelop the property. If the property burns down or suffers some other damage, tenants and lenders sometimes think it’s “fair or reasonable” to use the insurance proceeds to pay down the tenant’s debt owed to the leasehold lender. That doesn’t work.

Any purchaser of a leased fee wants to know that insurance money will always go to restore the property. That’s critical to pricing. Without it, the improvements might just go away, along with the tenant’s investment, leaving the owner with a burnt-out hulk of a building. That creates risk, including a risk that rent won’t be paid.

Investors also want insight into the stability and reliability of cash flow from the ground lease. It’s great to know that a tenant has successfully paid the ground rent for a long time, but an investor will often want to look under the hood.

The best predictor of future ground rent stability is the tenant’s success at the property. If they’re making a lot of money, they’ll probably keep paying ground rent. If they’re just squeaking by, that will worry the investor, who might lose interest as a result. Because of that dynamic, a future buyer of the fee estate will want any ground lease to require the tenant to provide financial reports on the profitability of its leasehold. Usually, the tenant already produces much more extensive reports for its lender so the burden is minimal. But the tenant will often not want to show its cards, so this can be a problem.

Any buyer of a leased fee also doesn’t like to see lease language that would allow a buyer (or foreclosure purchaser) of the tenant’s leasehold to disclaim responsibility for any previously accrued liabilities to the owner. If the new tenant gets off the hook, then those problems are going to end up in the owner’s lap. That doesn’t work.

As another area of concern for leased fee investors, ground leases often give the tenant great flexibility to change the use of the building, or even to demolish it. Investors don’t like “too much” flexibility. If a ground lease might allow the tenant to do something risky or use its flexibility for leverage against the owner, that can be a problem. And if the tenant does have the right to perform major construction – which it usually will – any leased fee owner or investor will want to know that the tenant has the financial resources and experience to finish it.

Too often when owners negotiate ground leases, they just focus on the future cash flow, their own agenda about the property based on their own historical ownership, and the financial delta the owner can achieve by turning vacant land into income-producing land. To maximize the value and security of that income, though, an owner must pay attention to the future requirements of the institutional investor and lending communities.

The points made in this article start that discussion but don't finish it. For more, visit [www.groundleasebook.com](http://www.groundleasebook.com).

Copyright © 2024 Joshua Stein. Published on Forbes.com December 20, 2024.