Lessor Beware!

A land lease is usually a partnership.

■ **ROBERT WETMORE**

Ground leasing is often viewed as an easy and riskless vehicle for a landowner to benefit from the long-term appreciation of real estate. More often than not, however, lessors incur substantial risks with a land lease, risks typically assumed by a joint venture partner. Willingly or not, the lesser is often the de facto partner of the lessee.

In order for landowners to properly assess a ground lease opportunity, it is necessary to identify the related risks, appropriately assess those risks, and project the financial return from the lease.

The purpose of this article is to give lessors some ideas about how they can identify and manage risk, based on Keyser Marston Associate's real estate consulting experience in assisting clients with land leases in West Coast markets. Prospective lessees might also wish to stay tuned.

Risks

Ground lease risks center on the concept of sharing economic returns. Often, the lease rent provisions allow the lessor to receive a share of the lessee's gross income from operations or from tenants, against or in addition to a stipulated minimum rent. Less frequently, the lessor will receive a share of the lessee's net operating income or net cash flow. In these arrangements, if the lessee's business succeeds, the lessor may also fare well; if the lessor fails, the lessor's return will be adversely affected. In relatively few transactions do the parties agree to long-term financial commitments for land rent that ignore the performance of the real estate.

Why do lessors agree to land rent structures based on project performance? In the case of prime properties, the lessor frequently believes that the lessee will "make a filling" and, hence, will insist on receiving a piece of that "action." Or the lessor may believe that real estate has historically performed well against inflation, and that it is better to secure an income stream tied to real estate performance than to sell the property. In the case of weak or "turnaround" properties, the lessor may have to subordinate a significant portion of the rent income stream both to the lessee's financing and to an entrepreneurial return to the lessee; a subordination requirement may dictate a lease structure based on project performance.

Land leases frequently involve multiple income payments or income "streams" from lessee to lessor, each of which bears its own distinct level of risk. In a multiple-use project, different types of lease streams may be negotiated for each land use.

Thus, prospective lessors considering leases based on project performance need to focus, not only on computer projections of rent and investment return, but also on the likelihood of actual receipt of those dollars in relation to the risks being taken.

Another major factor affecting risk is the track record of the prospective lessee in both developing and operating comparable types of property. This is crucial if the lessor intends to participate in the success (or lack thereof) of the lessee's enterprise.

In sum, the lessor must consider the market and financial feasibility of the real estate project. To mitigate its risks, the lessor should conduct an independent analysis of the project to gain confidence that it represents the correct improvement of the site.

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Negotiating a Ground Lease

Successful ground lease negotiations involve two separate but related steps. The first involves assessing the strength of the real estate. The second consists of evaluating the deal.

The "quality" of the projected income stream is based on a simple concept: the likelihood that projected payments will actually be received by the lessor.

Prospective lessors are frequently either too optimistic or too pessimistic about their property, or they confuse their costs with actual value in the marketplace. For example, a public agency that invests $10 million in infrastructure to make a development site available may mistakenly conclude that it is "entitled" to a fixed return on that investment, forgetting that the market may accord little or no economic value to those improvements. When landowners misjudge the strength of the development opportunities for their property, commonly one of two outcomes occurs: 1) the lessor establishes economic criteria that are too stringent, turning off prospective lessees; or

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Robert Wetmore is a principal with Keyser Marston Associates, Inc., a California-based real estate consulting firm offering, among other services, lease review. *This article first appeared in the Spring/Summer 1988 issue of KMA's* Transactions *newsletter.*

Figure 1
A Sample Land Lease Evaluation for a Lessor

Size of Income Stream	Proposal 1	Proposal 2	Proposal 3
Amount of Holding Rent	◐	●	◔
Amount of Guaranteed Rent	●	●	◔
Sum of Guaranteed and Percentage Rent	◐	●	◐
Quality of Income Stream			
Degree to Which Escalations of Guaranteed and/or Base Rent Are Unsubordinated	●	◔	○
Degree to Which Guaranteed/Base Rent Escalates Independently of Project Performance	◐	◔	●
Amount of Income from Participation Rent Formula and Degree to Which It Is Subordinated and Simple to Enforce	●	◐	○
Amount of "Net" Income to Lessor from Project's Sale/ Refinance	●	◔	○
Ensuring Performance/Protection of Lessor's Interest			
Is a Sequential Conveyance of Development Sites Provided?	●	●	●
Will Deposits/Letters of Credit Remain in Place through All Phases of the Project?	◐	◐	◔
Are the Deposits Sufficient and Is the Completion of All Phases of the Project Guaranteed?	●	◔	◔
Ranking of Proposals:	1	2	3

Legend: ○ = Very Deficient ◐ = Adequate ◔ = Deficient ● = Good/Excellent

Source: Keyser Marston Associates, Inc.

2) the lessor makes a weak economic deal, leaving dollars on the table.

To adequately assess the development opportunity, the landowner must carefully consider the following factors:

- the property's location and suitability for its intended use;
- the market feasibility of proposed use;
- the degree of difficulty associated with the regulatory/approvals process;
- site conditions that will affect the building cost; and
- the type/amount of mandated requirements for amenities and the like to be paid for by the lessee.

Too often, the landowner only considers the projected amount of the income stream to be generated by the ground lease when assessing the strength of the transaction. However, it is also important to consider the quality of the income stream. "Quality" is more elusive than "quantity," but quality is based on a simple concept: the likelihood that projected payments will actually be received by the lessor. Often, in land lease negotiations, balancing a known quantity against quality becomes a crucial issue: does the lessor wish to secure a high level of projected rent at substantial risk, or to accept a lower projected rent with greater certainty?

The most important factor in determining the quality of the income stream is the lessor's priority of payment in relation to the income generated or received by the lessee. Apart from a stipulated dollar amount of land rent without any relation to project performance, the highest priority that the lessor can command is a first claim on the lessee's gross income. As the lessor's priority becomes subordinated to other claims on the lessee's gross income, the quality of the income stream declines:

- In a transaction in which the lessor's return is based on net operating income (after expenses), the lessor, at best, is relying on the lessee's entrepreneurial strength in running a business. At worst, the lessor's income stream may be diminished by the lessee's creative accounting practices.
- In a transaction in which the lessor's return is based on net cash flow, the lessor incurs not only the risks identified with a net operating income base: his or her interest also may be subordinated to the lender and, occasion-