

# Lessor Beware!

*A land lease is usually a partnership.*

■ ROBERT WETMORE

**G**round 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 lessor 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 killing" 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 "turn-around" 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

The lessor should conduct an independent analysis of the project to gain confidence that it represents the correct improvement of the site.

should conduct an independent analysis of the project to gain confidence that it represents the correct improvement of the site.

## 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

*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			
<b>Quality of Income Stream</b>			
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			
<b>Ensuring Performance/Protection of Lessor's Interest</b>			
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?			
<b>Ranking of Proposals:</b>	<b>1</b>	<b>2</b>	<b>3</b>
<b>Legend:</b> ○ = 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-

ally, to a preferred return to the lessee. Lease payments based on net cash flow represent the lowest-quality income stream.

A frequently troublesome factor in leases based on a sharing of lower-priority dollars is that they are complex to negotiate and management-intensive to monitor and enforce. In these agreements, all cost, income, and expense items associated with the lessee's "bottom line" must be explicitly identified. Unwarranted fees and expenses charged by the lessee must be excluded. Strong legal documentation is a necessity.

Low-priority arrangements can be justified from the lessor's perspective in two respects. First, it may be necessary to subordinate to the lessee's entrepreneurial skills in order to create a feasible development opportunity or to attract a specific lessee. Second, the sharing of low-priority dollars also creates the possibility for a large

**The economic return to the lessor ultimately reflects the underlying performance of the real estate operated by the lessee.**

return to the lessor. It is simply a fact of real estate math that in a successful project, the rate of increase in bottom-line cash flow is much greater than the rate of increase in gross income. Often, however, the lessee will try to establish a low priority for the lessor's payment, without providing a corresponding increase in the level of return.

### **Evaluating the Income Stream**

With an awareness of the factors affecting risk, the lessor is positioned to evaluate specific lease provision. These are the basic steps in the review:

- First, determine the risk level associated with each income stream in terms of: (1) the lessor's priority position, (2) the lessee's capability to perform, and (3) market/financial feasibility.
- Second, assign discount rates to each income stream, related to risk. The

higher the risk, the greater the discount factor required. Returns on alternative financial instruments, such as treasury bills, corporate bonds, and lesser-quality financial instruments are generally the starting point for discount rate assignment.

- Third, quantify the discounted value of the income stream(s) over the lease term. In transactions based to any substantial degree on project performance, it is necessary to project the operating performance of the proposed project to provide an estimate of the lease income stream generated over time.
- Finally, compare the discounted value of the income stream(s) to the present fee value of the land.

If the discounted value for a long-term ground lease is within about 5% to 10% of the value of the land in fee, the land lease approximates the "market" value. If the discounted value is less than the fee value, the lessor should consider whether the income stream has been too highly discounted. If this is not the case, the transaction substantially favors the lessee, and



*The new Hyatt Regency Hotel in downtown Sacramento was built as a result of a complex ground lease and parking agreement with the Sacramento Redevelopment Agency.*

the lessor may wish to rethink the lease provisions or consider if a sale should be pursued instead. If the discounted value exceeds the fee value, the income stream(s) may not have been sufficiently discounted. Or the landowner may have negotiated an excellent deal and should sign immediately.

## **REAL ESTATE SUPERVISOR**

New York State Electric & Gas Corporation is a local investor-owned utility, dedicated to technological excellence & outstanding customer service. We seek an individual to direct & control the activities of a District Real Estate Dept. Also involves purchase, sale & lease of property obtainment of easement, deeds & permits. Must have experience in right of way acquisition, appraising & surveying. Supervisory experience desired.

We provide competitive salaries & benefits. Please send resume to Human Resources Dept:

**NYS ELECTRIC & GAS CORP.**

**NYSEG** *Good people.  
Good service.®*

**P. O. BOX 149, Liberty, NY 12754**

An Equal Opportunity Employer M/F/H/V

## Reminders for Lessors

If you are a prospective land lessor, remember at least four things before entering into a transaction:

- In most land lease transactions, the economic return to the lessor ultimately reflects the underlying performance of the real estate operated by the lessee.
- Landlord evaluations of deals must focus on the quantity of income projected by a pro forma but also must include a clear assessment of the likelihood of actual receipt of projected rent.
- Because the conditions and complexities of a land lease can mask the risk associated with achieving the projected rent levels, accurate assessment of the strengths and weaknesses of the real estate is essential.
- Land lease provisions must be tested against the current fee value of the land.

It is simple to say that lessors should not accept the entrepreneurial risks of a riverboat gambler at returns suitable for a holder of treasury securities. However, these issues are frequently complex, requiring careful evaluation. Analysis of risk and return may very well reveal that "more" is not necessarily better than "less." (IRMA)

Copyright Urban Land, October 1988. Reprinted by permission.



SOUTHERN NEW ENGLAND TELEPHONE PACIFIC BELL TELEPHONE MCI

## Continental Field Service Corporation

Serving Utilities, Pipelines,  
Government, & Industry . . .

- Land and Right of Way Acquisition
- Route Selection and Design
- Title Searches
- Mineral Leasing
- Comparable Sales and Appraisals
- Permitting
- Urban Renewal, Public Housing
- Rapid Transit Acquisitions
- Relocations
- Telephone Engineering
- Construction Inspection

See our brochure - the only company  
with a guarantee.

**Continental Field Service**  
**1-800-431-2806**

### NATIONAL HEADQUARTERS

37 E. Main St. • Elmsford, NY 10523  
800-431-2806

### WESTERN OFFICE

Jerry Shambre  
9198 Greenback Ln.  
Orangevale, CA 93309  
916-999-8703

### SOUTHEASTERN OFFICE

Chris Stapleton  
101 Burning Bush Ln.  
Greenville, SC 29607  
803-297-1717

SOUTHERN BELL GENERAL TELEPHONE PENNSYLVANIA BELL TELEPHONE CENTRAL TELEPHONE ALCOHOL GAS

PHILLIPS PETROLEUM NEW ENGLAND TELEPHONE AMERICAN PETROLEUM DONAHUE ENGINEERING WTG ATRT

NEW YORK TELEPHONE SOUTH CENTRAL BELL SHEL PIPELINE UNITED TELEPHONE NEW YORK POWER AUTHORITY CONTINENTAL TELEPHONE

## Data Search

*This column provides a continuing opportunity for persons in the appraisal field to locate or share information. Please send your requests to International Headquarters for publication.*

### Magazines

I would like to acquire a full set of *Right of Way* magazines. Please write or phone Dan Johnson, 936 West Ave. J-4, Suite 202, Lancaster, CA 93534; 805/945-1994.