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STEIN'S LAW

Solving the Ground Rent Problem


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For many decades, "standard" ground leases said that every 20 or 30 years, the ground rent would adjust to equal 6 or 7 percent of the current appraised value of the land under the building. Between those big resets, the rent would rise by maybe 2.5 percent a year or 10 percent every five years. That system protected the land owner from long-term inflation. It supported investment and financing by the actual operator of the building and its lender.

But in the last decade, and especially the last few years, traditional rent reset clauses have devastated investors in buildings on ground leases and their lenders. That happened in part because recent appraisal of commercial real estate – including vacant land – have used capitalization or discount rates closer to 3 percent or 4 percent. Land values sometimes rose further based on comparable sales for condominium development, which is usually not an option under New York ground leases but until recently was the favorite use of most New York City where zoning allows it.

When a rent reset formula applies a 6 percent or 7 percent constant to a land value derived in part from a much lower capitalization rate and from the value of potential condo development, ground rent can consume the entire net operating income of the building, or more.

That dynamic recently played out at Lever House. It helped drive the dramatic recent devaluation of the Chrysler Building. In a less visible transaction, an upcoming rent reset led the tenant and investor to give the lease back to the leasehold lender, who soon surrendered the building to the land owner. (Conversely, some rent resets in the early 1990s created leaseholds that became very valuable to tenants.)

Developers negotiating ground leases today often hesitate to agree to traditional land value rent resets. Without those resets, though, the ground rents look silly after a couple of decades. Land owners remember the 1970s.

Developers sometimes propose to live with a traditional land value rent reset, with a percentage cap on any resulting rent increase, measured either from the starting year or the year before the adjustment. The land owner assumes, of course, that any such cap will erode the desired protection from inflation. (The lease will typically still have periodic "little bumps." Though nice, they don't protect the land owner from major inflation either.)

With some difficulty and agony, a land owner can, at least in theory, get comfortable with a cap on rent resets, or even with a fixed dollar amount of rent for each year during the lease. The land owner projects out the worst case and discounts it to present value at a rate compensating for inflation and other risks. The land owner then decides that the present value of the rental stream beats any other likely deal, including a ground lease at a lower starting rent with better increases, or an outright sale. It's just like valuing a long-term corporate bond. Though logical, this approach does not have much appeal to land owners.

Some new ground leases use consumer price index (CPI) adjustments for bi rent resets every 10, 20, 30 years. If not capped they give the land owner reasonable protection against inflation, though not against the risk that real estate values rise faster than CPI. Any developer worries that CPI might rise faster than real estate net operating income.

In response, some ground lease players cap the bi resets, whether based on land value or CPI, at a cumulative compounded increase of 3.5 percent a year. That's higher than recent inflation and real estate appreciation over any significant lookback period. Many believe that even Manhattan real estate has not appreciated more than that, on average, over the long term, after taking into account, for example, the NYC financial crisis of the 1970s, the S&L crisis of the early 1990s, 9/11, the Great Financial Crisis of 2008 and 2009, and today's static or gently declini ng values driven in part by politicians who hate the re al estate industry except as a source of tax revenue a nd fines.

As a result, if the parties agree to cap the big resets at 3.5 percent cumulative or compounded, then the developer limits risk while giving the land owner reasonable protection against inflation – provided inflation doesn't substantially exceed its historical long-term average. That formula gives each party some protection, although it's not a complete solution. A perfect solution probably doesn't exist in this world.

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