



What's the Deal By Daniel Lesser

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Keeping ground leases on solid economic footing

(The views and opinions expressed in this blog are strictly those of the author.)

Hotel ground (or land) leases originate as long-term rentals of unimproved land. During the term of an agreement, a property's expenses are paid by a tenant who can develop a hotel and finance construction of those improvements. Hotel ground lease terms typically range from 50 to 99 years and may include multiple extension options of 10 years or more. Essentially, during the term of a lease, title of the land (aka leased fee position) is severed from ownership of the improvements (aka leasehold position).

Ground leases invariably contain escalation clauses that increase the rent at predetermined intervals. Within major dense urban areas such as New York City, as commercial property values rise, hotel owners face rent increases at stipulated "reset" dates during the term.

On numerous occasions, I have encountered leaseholders who discover that ground leases can contain ambiguous language that allows rent increases to be calculated based upon the value of a property as if it were "unimproved and unencumbered." Such language, which principally means the land should be valued as though vacant at its highest and best use, can threaten ownership economics for tenancies.

During a period of expanding real estate markets, alternative uses such as residential and office may be deemed more lucrative than hotel development, resulting in a contentious, and on some occasions, a perilous valuation process for leaseholders.

Typically, ground leases mandate that rent reset disagreements be settled via arbitration, whereby each side retains an independent appraiser to prepare separate property valuations. Many ground leases include elements of game theory to encourage both sides to produce value conclusions that are not too far apart. If appraisal results dramatically differ, an arbitration panel may be empowered to commission a third independent appraisal, and the proposed value conclusion that is furthest from it is then dismissed.

Unknowns surrounding impending ground rent resets places negative pressure on the market value of leasehold positions as well as options for refinancing property. With everything said, landlords or ground lessors may prefer to maintain their passive property ownership role rather than take on the task of seizing a property and operating it themselves, or re-leasing to another tenant who will only be willing to pay economic rent based on the current improvements.

Caveat emptor. Tenants, both original since occupancy inception as well as investment ventures that acquire seasoned leasehold positions, must carefully consider the economic terms of a ground lease and factor into their underwriting the potential for dramatic ground rent increases due in part to resets predicated upon the evolution of a strong real estate submarket.

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