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With a Challenged Real Estate Investment Climate, Ground Leases Attract a Bigger Following

One factor driving interest is property owners using ground leases to unlock capital in a market where liquidity is tight.

Beth Mattson-Teig | Aug 15, 2023

Ground leases are stepping out of the shadows of commercial real estate buildings and commanding more attention from both buyers and sellers looking for alternative funding sources.

Ground leases run the gamut from the land underneath fast food restaurants to parcels beneath hotels, apartments, industrial warehouses and office towers. “I've definitely been seeing more activity around ground leases,” said Camille Renshaw, CEO and co-founder of B+E, a real estate brokerage firm specializing in net lease properties. B+E is currently involved in several active transactions in New York City that involve large ground lease deals beneath high rise buildings.

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One factor driving the spike in activity is that some property owners are using ground leases to unlock capital in a market where liquidity is tight. For example, an owner might sell off the ground lease and take out a mortgage on the building to get a better overall blended rate on their cost of capital, noted Renshaw. Or if an owner needs equity to recapitalize a loan or pay for renovations or tenant improvements, a ground lease is an alternative to raise the needed capital rather than looking for loans in a market where traditional lenders have pulled back.

“On the larger transactions, there are certainly some opportunities right now,” says Renshaw. In particular, there are a lot of office buildings in core markets, such as New York City, San Francisco and Chicago, that are struggling with lower occupancies. These properties are often owned by good operators that are savvy enough to recognize that they can break the property into pieces to raise needed capital, she added.

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Small vs large deals

The investment market for ground leases varies widely depending on the price point. On the smaller end of the spectrum, ground leases priced below $4 million tend to attract all-cash buyers, including 1031 exchange investors, individuals and family offices. That demand has kept pressure on pricing. Ground leases for popular fast-food brands, including McDonald’s, Raising Cane’s or Chick-fil-A, are continuing to trade at cap rates around 4.5%. “At a time when cap rates are moving up, ground leases have hung in better than the overall sector, especially the more in-demand ones,” said Randy Blankstein, president of The Boulder Group, a real estate service firm specializing in single tenant net lease properties.

One reason for that vibrant buyer pool is the price point. Two years ago, people with $4 million to invest or reinvest as part of a 1031 exchange might be looking to leverage that equity to buy an $8 million to $12 million property. Today, they are more likely to stay close to the original $4 million. “So, there are just more people in that ground lease price point than there has been historically,” added Blankstein.

Another reason ground leases are popular is that they are typically structured with 10% rent escalations every five years, whereas most leases within the net lease investment market are closer to 5% increases every five years. “With interest rates and inflation increasing, those rent escalations are very appealing to buyers, and that is something that is much more important than it was historically because of the current interest rate and inflation environment,” Blankstein said.

The higher-priced end of the ground lease market has a different dynamic. Part of what is driving demand is favorable pricing. Five years ago, long-term ground leases under great real estate in New York City were trading between 2% and 3% percent cap rates. Today, ground leases are going for close to a 6% cap rate, noted Renshaw. “The smartest people in the room that can afford a ground lease that is hundreds of millions of dollars are thrilled and engaging with those sellers,” she said. A lot of the interested buyers are family offices or ultra-high net worth investors with generational wealth, and those buyers want long-term stable cash flow and the opportunity to build equity, she adds.

Another active buyer that is capitalizing on interest from property owners is Montgomery Street Partners. The commercial real estate investment firm launched its non-listed Ground Lease REIT (GLR) in 2020 with an initial capital raise of $500 million. GLR is positioning its ground leases as an alternative to conventional financing by offering an interest-only, 99-year financing product. The firm targets deals that are between $10 million and upwards of $200 million in the top 30 MSAs.

Buyers like the bond-like qualities

Investors like ground leases because they are conservative, passive and generate steady predictable cash flow. “Families love this idea of getting cash with no management oversight required,” said Pete Stone, managing partner at Trinity Real Estate, a real estate wealth management firm. “The beauty of it is that you don’t have to do anything other than collect the rent for the most part.” Most leases require the developer or building owner to be responsible for everything, including taking responsibility if there is any environmental spill or contamination, he adds.

Trinity Real Estate is not actively involved in the buying and selling of ground leases for its clients, rather most of the families it represents want to structure ground leases at properties they own to create a long-term source of stable cash flow. “On the land side, a lot of our investors immediately think, ‘Wow, how cool would it be to be involved in a development?’” Stone said. However, most families don’t have the experience, track record or the risk tolerance to be developers. Contributing land to a development that is structured as a ground lease is one way to participate, he added.

“Another reason why these investors love it is because when you have improvements worth a significant amount of money on top of the land, if there is a default, the entire property goes back to the landowner,” Stone said. “So, the chance of default is extremely low on a lot of these ground leases. For some properties, it’s almost as safe as treasuries.” Typically, ground leases are structured with 40 to 50 years of term. Once the term is up, the owner of the building is going to either want to renegotiate or buy the land, which creates an opportunity for the landowner to renew the ground lease at more favorable terms.

Limited buying opportunities

When structuring or buying ground leases, investors need to pay close attention to the rent escalations. “It's important to have the ability to keep up with inflation or what we call mark-to-market provisions where you have an ability to reset the lease rate based on what's happened in the market,” Stone said. For example, Stone is currently renegotiating a ground lease that was originally done back in the early 1970s where the rent is extremely low and escalations have not kept up with market rates. “The increase in land value is all accrued to the owner of the improvements and very little to the owner of the land,” he said.

Another challenge is that there isn’t a lot of turnover or reselling of ground leases, because people tend to buy them for a long-term hold. Most ground leases are structured as long-term leases, usually for a minimum of 20 years and sometimes up to 99 years. In addition, a lot of the bigger deals tend to be completed as off-market transactions.

However, there does seem to be a wave of new ground leases now coming to the market. For example, more shopping center owners are looking to develop outparcels and pad sites in their large parking fields that is creating new ground lease opportunities associated with restaurants, hotels and entertainment uses. CBL & Associates Properties has used ground leases as one of the tools to help finance its ongoing redevelopment projects. For example, the mall REIT completed a ground lease on a new pad site for a LongHorn Steakhouse at its Cross Creek Mall in Fayetteville, N.C.

“A lot of owners have tried to monetize some of their outparcels because of the cap rate differential,” Blankstein noted. Ground leases typically trade at a premium, or a lower cap rate, compared to fee simple properties that include the land and building. So there is an opportunity to sell a ground lease at a low cap rate and reinvest the money elsewhere at a higher cap rate, he adds.

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