Ground Leases

A Guide for Developers, Public Officials, and Lenders

Preface

In recent years, transit agencies have discovered the ground lease to be an effective tool for funding transit improvements. By leasing underutilized public property near frequent transit service to a private developer or business owner, transit agencies can "capture" some of the increase in land value that is a result of public investment in transit.[1] This practice of "value capture" has been recognized by the Federal Transit Administration (FTA) as an effective way to fund transit, because it allows transit projects to realize a return on investment and reduce the need for taxpayer dollars for transit.[2]

Another benefit of ground leases is that they allow the landowner control over a property. This means a transit agency serving as the landowner can ensure any development on public land is transit oriented and conducive to increasing ridership. These twin benefits of facilitating transit oriented development (TOD) and capturing the value from transit investments have made ground leases on transit-adjacent public land increasingly popular.

The practice of ground leasing is complex, however, and the option to sell a surplus property is often a simpler alternative which yields a more immediate financial payoff. As transit systems nationwide expand, transit agencies will increasingly face the question of whether to sell or lease surplus property. This guide is designed to provide developers, public officials, and lenders with a general understanding of the merits and challenges of ground leasing public land for transit oriented development.

What is a Ground Lease?

Ground leases are a long-term, land-only rental in which the tenant pays for the right to use the landowner's property to construct a building or to put the land to another use.[3] An inherent feature of a ground lease is that it separates land ownership from building ownership, with the land being owned by the landowner while the building and other improvements are owned by the tenant.

This arrangement necessitates several other features of ground leases. Because a building is tied to the land it is on, a ground lease must specify what is to become of any improvements once the lease ends. This is often done through a "reversion" provision which states that the building and all other improvements become the property of the landowner at the end of the lease. This reversion clause means that ground leases must be long-term, generally between 50 and 99 years, as it would not be financially viable for a tenant to construct a building they must soon forfeit.

The separation of land and building ownership also results in the need to negotiate the maintenance and tax responsibilities for the property for the duration of the ground lease. While these issues are settled on a case-by-case basis, the most common arrangement is that maintenance and property taxes are the responsibility of the tenant. This arrangement is typical because it meets the need of the tenant to have independence over the day-to-day functions on the property, and allows the landowner to assume a passive role in which their main responsibility is collecting the rent.

The Pros and Cons of Ground Leasing

The Developer's Perspective

The most frequent complaint against ground leases is that they require too much time to negotiate and make it difficult to obtain financing. Such negative perceptions are not without merit. Ground leases often require more time to negotiate than a simple sale, because ground leases require an ongoing relationship between multiple parties, each of which must have their exact responsibilities specified.[4] Likewise, it may be more difficult for a developer to obtain financing for a project when they are not the landowner because they are not able to use the fee interest in the land as security for a loan.[3] Nevertheless, ground leases are common instruments for commercial and retail development and lenders may be more willing to offer leasehold financing than developers realize.[5]

For a developer to see the value in a ground lease, they must look past the complexity and see the benefits that a ground lease can deliver. The most substantial of these benefits is the elimination of initial land acquisition costs.[6] As buying land is generally one of the largest up-front development costs, removing this expense can benefit the financial outlook of the project.[6] In addition, there may be tax advantages to a ground lease, as rent is generally deductible for federal and state income tax purposes.[7] These advantages mean that while ground leases come with added challenges, they can deliver significant benefits to developers as well.

The Transit Perspective

For a transit agency, ground leases are preferable to disposing of a property in most situations.[7] From a financial outlook, the Present Value of a ground lease is generally greater than the for-sale value of the land.[8] The reason for this is that government bodies typically employ a much lower discount rate* than private developers. This means that public entities may view the cumulative rent accrued over the course of the lease as more valuable than a private developer would.[8]

The financial benefit of ground leases is compounded by the fact that transit-adjacent land is increasingly viewed as prime real estate, meaning that ownership of such land can pay off in the long run.[1] This is the principle of value capture that the FTA has recommended as a means to fund transit. As land values near transit increase over time, transit agencies that own that land can realize a return on investment that decreases the need for funding from other sources, including taxpayer dollars.

Ground leases are generally preferable for meeting an agency's TOD goals as well. Because ground leases allow a landowner to retain some say over how their land is used, a transit agency can ensure any development facilitates efficient transit operations and is compatible with increasing ridership.[7] It is difficult to maintain similar control when ownership of a property is sold.

Discount Rate = The rate at which future income is discounted to determine the present value of that income. The discount rate adjusts for the fact that a dollar earned or spent today is more valuable than a dollar earned or spent in the future due to the time value of money. Discount rates vary by party, however, public agencies frequently use the rate set by The Office of Management and Budget.[7]

When to Ground Lease and When to Sell

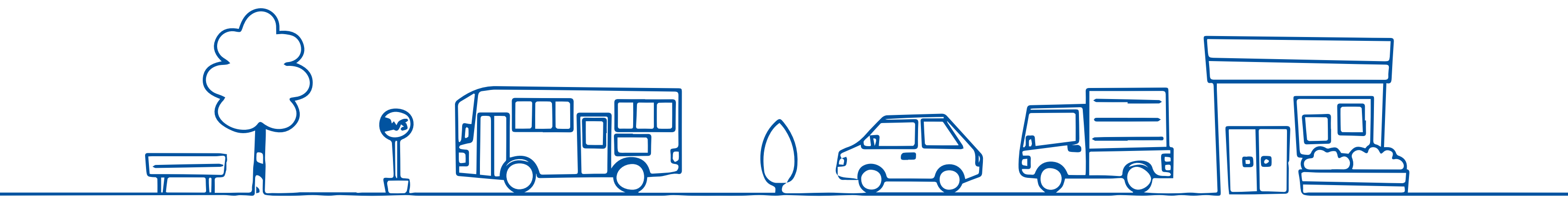
Transit agencies often find themselves in the possession of property that is underutilized or no longer needed for transit purposes. While determining what to do with such a property depends on a case-by-case consideration of the property and an agency's priorities, there are several factors that make a property more suitable to being ground leased or sold.

Factors that Favor Ground Leasing

- **The property is needed for transit purposes (station, bus turnaround, park and ride, etc.)**
- **The market is supportive of immediate or short-term development**
- **The property has high potential for TOD**
    - » **Adjacent to an LRT or BRT station, or high-frequency bus service**
    - » **Located in a walkable, mixed-use area**
- **The property is likely to increase in value over time**
- **A developer has shown interest in a ground lease**
- **The proposed ground lease has a high Present Value compared with the appraised value of the land**

Factors that Favor Selling

- **The property is no longer needed for transit purposes**
- **The property is unlikely to be developed for some time**
- **The property has limited potential for TOD**
    - » **Property is not adjacent LRT, BRT, or high-frequency bus**
    - » **Property is surrounded by auto-centric development**
- **Developers have been reluctant to consider a ground lease**
- **A favorable offer has been made to purchase the property**



Typical Provisions of a Ground Lease

Term Length	Anywhere from 50 to 99 years is common.[6] Generally, developers will push for longer terms with options to extend in order to postpone the date when they lose control of the land and ownership of the buildings or improvements. From a landowner's perspective, all else being equal, a shorter term is better as it reduces the time in which the landowner will not have full control of their land.[8]
Initial Rent	Initial rent is determined by multiplying a ground lease capitalization rate by the appraised value of the land. For example, if a property is valued at $1 million and the ground lease cap rate is set at 5%, the rent for the first year would be $50,000. The ground lease capitalization rate is negotiated based on local market conditions and a tenant's credit history.[8]
Rest Escalation	Because ground leases are long-term, setting a proper rent escalation is essential if the property is to obtain a fair return on investment for the landowner. There are two ways in which this is commonly done. One is to tie the rent to a Consumer Price Index (CPI) or another measure of inflation. Doing so ensures that the rent will not lose value over time. An alternative measure is to have appraisals of the land conducted at regular intervals. Each of these methods should not be viewed as mutually exclusive as they ensure a fair rent in different ways. A CPI index maintains that the value of money remains constant, while a regular appraisal measures changes in the specific property's value. For TODs in which transit is expected to increase the value of the property over time, ensuring that both appraisals and an index are used is important to capture the full value of the property.
Land Use Restrictions	The landowner should maintain control over what is built on their property in order to ensure it is consistent with their goals. When ground leasing public land near transit, these goals include maintaining transit operations and increasing ridership. If a property is currently used as a transit center, bus turnaround, or park and ride, the ground lease should state that the landowner has the right to veto any development that would negatively affect transit operations. Similarly, if the project is intended to be transit oriented, the public landowner should maintain the right to veto any land use that is not compatible with producing transit ridership.
Reversion	A ground lease should provide that on expiration of the lease, all improvements become the property of the landowner without payment, free from all liens, and in good condition.[9] The landowner should also maintain the right to require the tenant to demolish any improvements and return the land to its original state at the landowner's option.[6]
Subordination	In a subordinated ground lease, the landowner allows their fee interest to be placed as a security on any financing attained for the property.[9] Although this practice can make it easier for a developer to obtain financing,[10] it generally should not be done on public property in which a transit interest is maintained due to the possibility of foreclosure. Furthermore, if the FTA has a financial interest in the property, their guidelines require a transit agency to maintain continuing control over the property. Such guidelines likely forbid any subordinated ground leases.[11]
Due Diligence	All due diligence that accompanies the sale of a property generally applies to a ground lease. It is the usually tenant's responsibility to conduct research on the environmental and financial conditions of the project and to obtain all necessary approvals and construction permits. If during their due diligence, the tenant comes across any problems associated with the condition of the land, it is usually the responsibility of the landowner to mitigate them.
Maintenance	The maintenance of all improvements is generally the responsibility of the tenant, unless there are parts of the property for which the landowner wishes to control the maintenance.[12] If the property has active transit components, the transit agency or public landowner will likely want to oversee the maintenance for such facilities. An operations and maintenance agreement may be developed to delineate roles and responsibilities.

Summary

While they may appear complicated, a ground lease on public land can result in significant benefits for a transit agency and a private developer alike. From a transit agency's perspective, ground leasing can create a consistent source of revenue, ensure the property remains compatible with transit, and allow a return on investment for transit projects. From a developer's perspective, ground leasing can eliminate large, upfront land acquisition costs and create an operating expense that reduces income taxes. While the specifics of each situation ultimately determine whether a ground lease is desirable, the practice of ground leasing is a tool that transit agencies and developers alike should be familiar with. As transit agencies nationwide expand their networks and seek to find creative sources of revenue, ground leases are now a more valuable tool than ever.

References

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