



JIM FRAZIER

Investing from the ground up

Ground rents on commercial property constitute an investment with characteristics different to that of traditional property. This article depicts the processes by which they are created and provides insight into the attractions for investors...

Commercial ground rents are normally created when a landowner, the freeholder, grants a leasehold interest to a developer, who constructs a building on the land. Normally the developer is granted a long leasehold interest for a fixed period, say 125 years. The return to the freeholder is through a combination of an upfront premium on the grant of the lease, and an annual ground rental payment. This can be as little as a peppercorn, but is normally a percentage of the open market rental value of the land or the buildings constructed on it. The arrangement can be beneficial to both parties, the developer is able to defer some of their upfront costs by minimising the expenditure on land. The freeholder is able to take advantage of the specialist skills of the developer in devising and letting a suitable scheme, and receives a secure income stream.

Freeholders will often sell on their interests to long term investors. The attractions of the ground rent investments are myriad. The ground rental income is secure, as it is normally a small percentage of the open market rental of the buildings on the land. As such should the leaseholder default a large reversionary interest would be realised. The income stream from commercial ground rents is more similar to that of a bond than a traditional property rental income, with the income being fixed or rising for the residue of the leasehold term.

The rental review system for commercial ground rents allows their investment performance to mirror a wide variety of income streams. Increases can be fixed in line with the Retail Price Index, the underlying rental value of the site or fixed amounts based on an annual compound increase of two to three percent. The frequency of rental increases have

a large bearing on the value of the ground rent, assuming the income is reviewed on an upward only basis the more frequent the reviews the higher the Net Present Value of future rental payments. This has a strong affect on values.

Traditional commercial ground rent vendors include councils and large landowners, who often have large industrial holdings on which ground rental leases were granted in the 1960s-1980s. These are normally sold at public auction to ensure there is a clear demonstration of seeking best value for the taxpayer. Purchasers vary depending on lot size and initial yield, but normally come from a cast including institutional investors, family trusts, private investors and specialised ground rent investment companies.

Many of the traditional irritants of property investment are absent. There is little risk of void periods, few management responsibilities and little reason to interact with the occupants, whose contractual relationship is normally with the head leaseholder.

Initial yields are low, with much of the value stored in the deferred reversion of the underlying property. As such ground rents tend to be unable to support high loan to value loans, and most investors rely on equity funding in lieu of bank finance.

To conclude commercial ground rents reflect an opportunity for the cautious investor to gain exposure to property with few of the hazards associated with traditional property investment. This is negated to an extent by the scarcity of high quality investment stock and specialised knowledge required to 'cherry pick' attractive opportunities. 🏠

FOR MORE INFORMATION:

Jeremy Davies is Principal of Ground Rent Company Elmdon Real Estate LLP. Visit elmdonrealestate.com. Email info@elmdonrealestate.com or Phone 0800 015 2500.