

# Worth your while

Commercial ground rents combine both the benefits of a fixed income with an ability to add value.

Jeremy Davies explains

Commercial ground rents involve the freeholder leasing land to a developer who agrees to pay an annual ground rent for the lease term. The building can then be leased to an occupational tenant, with the developer as head leaseholder. As an investment, ground rents combine secure income, reversionary growth and the opportunities for exceptional returns through active asset management. Income valuation depends on the mechanisms for growth – as set out in forthcoming rent reviews – such as frequency, unexpired term and the tenant's covenant quality. There are also many opportunities created by restrictive use clauses in the occupational leases.

The rent reviews come in a mix of different formats. They can reflect hypothetical characteristics of a property, such as the site's rental value as open land, be geared to the open-market rental value, offer fixed uplifts or reflect government statistics such as the Retail Price Index. Security is provided by the income's reversionary nature, rent received is normally at a discount to open-market rent if the head leaseholder defaults. As such, investors can speculate on a variety of indices when buying ground rents, with inflation-linked reviews making them a proxy for government bonds or rent reviews geared to the open market, providing exposure to occupational sub-markets across the country.

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The frequency and nature of the rent reviews also affects the value, broadly, the more frequent, the better net present value (NPV) of the future receivable income. Vagaries as to the mechanism for reviewing the rent can also have a detrimental affect on values, as there is a premium placed on the certainty of knowing how the income will change in future. As such, a landlord owning a ground rent with 20 years to go until a poorly defined rent review, can see a rapid uplift in value if the leaseholder is prepared to accept a premium to 're-gear' the lease to reflect fixed five-early reviews to the changes in the Retail Price Index.

The unexpired lease term has a large bearing on the value of a commercial ground rent. The shorter the term until reversion, the higher the NPV of receiving vacant possession. An investor would normally want to apply a 'wholesale discount' to reflect the delayed nature of the receipt, somewhere close to 40%. This creates an opportunity for a valuable uplift if the leasehold interest can be 'married' with the ground rent by the landlord, as the value of the whole would be greater than the sum of its parts.

The quality of the underlying tenant's covenant is significant, although this can be tempered by the quality of the underlying property. On secondary property, a quality long leaseholder provides security and eradicates the hassles of chasing errant tenants. On more attractive properties, a defaulting long leaseholder offers an opportunity to obtain vacant possession, and so can be a blessing in disguise. Shrewd



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investors will look at their outlay on the ground rent as a percentage of the value of the underlying property to ensure sufficient security is afforded in the event of default.

Occupiers of leaseholds subject to ground rents can benefit from the arrangement also. A leasehold with a 30-40 year term can be purchased relatively cheaply, and provides the occupying business with a secure base in the medium term. If their business is successful or they want to develop the property further, they can then purchase the freehold ground rent and marry the two interests together. Most ground rent owners are delighted to sell to the long leaseholders, as their ability to pay 'special purchaser' prices can provide profitable exit routes. Unlike in residential ground rent ownership, however, there is no enfranchisement mechanism where commercial tenants can force a sale, apart from a few cases where the property was originally in residential use.

Vendors are often councils or public bodies, who typically own ground rents on tranches of land sold on long leases in the 1930s to the 1960s. Commercial owners tend to be pension funds, family trusts or private property companies, who value the combination of secure income and opportunity for out-performance in the medium term. Sales by public bodies normally occur through public auction, while private vendors normally deal 'off-market' through surveyors. The security of income has meant recent market conditions have had less of an impact on valuations than for more secondary property where there might be the need to re-let vacant units in the midst of a recession.

Commercial ground rents combine the characteristics of fixed income with the ability to add value through entrepreneurial active management. As such, they are sought-after investments for a wide variety of buyers, and liquidity should remain for those looking to sell – even in these troubled times.

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For more information on ground rents, visit [www.rics.org](http://www.rics.org) entering 'ground rents' in the search facility