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Underlying value

The low-risk, low-volatility ground rent market is holding steady, despite the rapid decline in values and transactions in the broader residential market. Jeremy Davies explains how ground rent sales can provide vital cash flow



Ground rents are something of an anomaly in the residential property sector. Created when long leasehold interests are sold, typically on new-build apartment schemes, they provide both a means of ensuring communal maintenance provisions are administered (albeit funded by service charges), and a valuable source of income for developers and investors.

In new-build blocks, the sale of ground rents to investors can generate a capital sum equal to around 3% of the scheme's gross development value, or as little as 0.5% if the leases are poorly structured.

The financial stress many residential developers are under has contributed to an increase in the supply of ground rents coming to market. The main vendors of ground rents are builders of new apartment blocks, who are currently faced with low sales volumes in a declining market. In such conditions, the sale of a historic ground rent portfolio can provide a vital lifeline to cash-strapped developers and much-needed turnover for agents.

Recent reductions in the Bank of England base rate have reduced funding costs for ground rent portfolios, but debt is more difficult to obtain and loan-to-value ratios have fallen. Most buyers are paying cash, and intending to 'gear up' at a later date. This against the background of growing scarcity of residential development finance, which provides developers with a strong incentive to monetise any assets through a willing market of potential purchasers. There is a visible disconnect between the availability of finance for development and long-term investment, with the former being shunned as risky at a time of falling capital values and few buyers for the end product.

The recession has caused inflation to decline rapidly from its height of close to 5%. This has meant ground rents with rent increases linked to inflation figures such as the Retail Price Index have become less attractive, with regular fixed increases providing more certain growth for the long-term investor.

The current climate has meant that prices have fallen year on year, because the scarcity of cash has driven up the target returns of those in a position to buy. With a large amount of ground rents being actively marketed, run-of-the-mill stock that would have been attractive a year ago is being overlooked in favour of ground rents with potential for out-performance in the medium term.

Motives and drivers

A purchaser of ground rents has a very different risk profile from a vendor. The apartment scheme is likely to have been speculatively built, with the developer relying on capital receipts from apartment sales to repay development finance and yield an immediate development profit. A ground rent purchaser is likely to have a different approach. On new-build stock, the variables that make the apartments saleable – location, aesthetics, square footage and rental yield – make very little difference to the ground rent purchaser. He/she would normally look first for rent review provisions, with a strong preference for regular fixed uplifts. Historically, management and insurance could be lucrative for the ground rent owner, but this is changing with increasing use by long leaseholders of their Right to Manage.

Without debt funding, the return on ground rents is of little interest to investors; it is only by 'gearing them up' with bank funding that they become worth holding. Such funding is far less accessible than it is for land or residential property purchases, and is usually available only in

tranches valued at more than £2m. Developers who retain ground rents are often unable to borrow against them, and therefore cannot use the funds for land purchases or dividend payment.

1. Large ground rent portfolios allow for economies of scale in the administration of ground rent invoices and the appointment of managing agents
2. The two parties have very different target returns, reflecting their respective risk profiles. Developers taking substantial risks by purchasing land and investing in materials might rightly expect an annual return on equity of around 30% for the duration of a project. Ground rent investors usually have an aversion to risk, so their target returns might be closer to 15%. Developers with knowledge of local markets and future land transactions in the pipeline often prefer to employ their capital in more lucrative activities. The credit crunch has accentuated this, as 'cash in the bank', available for spending on distressed land sales, is valued more highly than a steady but unspectacular income stream.

Cautionary note

To avoid conflicts of interest in the selection of managing agents, it is important that vendors insist on a separation of the management and ownership entities, which can be provided for in the contract of sale. When a developer is pre-selling ground rents on a new development, it's worth considering setting up a residents' management company to be run by the long leaseholders, which would take responsibility for the annual ground rent payment. This can be a reasonable solution for all the parties involved, as the landlord's administrative costs are reduced, the leaseholders take responsibility for their own environment and the developer gets both a reputation as a reasonable vendor and a capital sum for the ground rents.

The extreme on the developer's part is to include a 'share of freehold' with each long leasehold purchase. This is an expensive tactic however, as the ground rent investment sale can generate in excess of £2,000 per unit as a capital sum, while it will add little of that to the initial sale price of the apartment.

Steady demand

Transactions in the market as a whole have almost ceased, yet there still seems to be a demand for ground rents. Why?

1. **Relative lack of volatility in valuation compared to the rest of the market.** As the value of new-build ground rents largely reflects multiples of passing income and not capital values of the underlying property, the decline in residential land values caused by falling property prices has not yet been reflected in ground rent sales prices. Having said that, the scarcity of debt finance has affected the pricing of tertiary new-build ground rents, largely those with poor rent review provisions or very long leases.
2. **Shortage of good-quality stock.** Just because a ground rent is payable does not make it an attractive investment. It is rare to find truly 'triple A' stock even in a market swamped with vendors, and attractive lease structures will always have a scarcity value.
3. **Fear of defaults in other property types, prompting a 'flock to safety'.** Ground rents carry no risk of void periods, very little risk of tenant default and require minimal direct maintenance. As such, they are attractive to those who fear rental voids on tertiary commercial property in the wake of recession, or falling capital values on rented residential property. While there is little scope for rapid capital uplifts, the downside is limited. In a market dominated by fear, this is attractive.

Where to find them

The availability of new-build ground rents largely mirrors the pattern of speculative building over the last 10 years. There is an abundance of ground rent parcels in the North West, the fringe areas of Greater London and the M4 corridor. Interestingly, on more historic stock (mainly 'legacy purchases' from retiring developers) leases normally start between 1985 and 1989, mirroring the 1980s property cycle. There is a corresponding scarcity from more distressed times – for example, the author is yet to purchase a ground rent starting between 1990 and 1995. The current slump in new build might lead to a similar drought of new stock in future years.

Increasing the value of ground rents

1. **On schemes that are yet to be built.** It is worth discussing the annual ground rents and rent-review provisions with a ground rent investment company prior to instructing solicitors to draw up leases. Often investors will be able to provide standard leases that contain attractive provisions and assist with finding reputable local managing agents. It is becoming increasingly attractive for developers to 'pre-package' their sales in bulk to ground rent investment companies, who then release monies post-exchange to the developer, which helps fund the development. In some instances this can replace the developer's expensive mezzanine finance, while providing an attractive forward-purchasing schedule for the ground rent purchaser.

Ground rent sales can yield 4% of GDV, but a more normal figure is 2-3%. By pre-selling ground rents, the developer also avoids having to offer the right of first refusal to long leaseholders, as transactions can be structured to effect an exchange prior to 50% of apartments being sold and completion of the sale of the last apartment. This avoids the statutory two-month expiry period connected with Section V notices (the rights of pre-emptive purchase a landlord has to serve on the long leaseholders when he is selling the freehold interest), and provides certainty for both parties.

2. **On completed schemes.** It is too late to do much to improve the value of retained ground rents. It is worth collating all the relevant information – sample leases, office copies of title, management provisions, etc – prior to approaching a ground rent investment company. This will allow the company to quote rapidly, and avoid confusion over the particulars of the subject property. Additionally, paperwork showing the contact details of the long leaseholders will allow the ground rent purchaser to serve the Section V notices rapidly, which speeds up the transactions and reduces the vendor's legal costs.

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