

Considering a ground lease? Consider these questions when vetting prospective ground tenants - by Robert Khodadadian

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In today's real estate market, creativity is required for a deal to make sense for all parties involved. One example of this creativity is to ground lease a property instead of the conventional sale. Although ground leases are not a new concept, many people are not familiar with it and therefore do not take advantage of the opportunities it presents. Ground leases are an effective tool that property owners can use to maximize the upside potential of their asset without the expenses associated with transferring ownership of the property through a conventional sale. In the simplest form, a ground lease (master lease) is a long-term net lease (usually 49 or 99 years) of land including any improvements (if any) on the said land.

Once a landlord decides to ground lease their property, they must pick the right ground tenant to partner with. Unfortunately, often times owners choose a ground tenant based solely on receiving the highest offer for their property. However, this should not be the only factor to take into consideration. Landlords must properly vet any prospective ground tenant and should take into consideration asking the ground tenant my “Top 5” questions as outlined below.

1. What is the ground tenant’s transaction history? Have they done a ground lease in the past?

Ground leases are known to be very complex transactions and are in many ways like a partnership. It is crucial to choose a sophisticated and experienced ground tenant to successfully negotiate the terms of the lease. Working with a ground tenant that has past experiences with ground leases can provide the owner with comfort and guidance through the sometimes grueling lease negotiations. Furthermore, experienced ground tenants can provide tax efficient structures to help save the landlord money. An example of this is compounding/deferring the taxes associated with an upfront payment made by the tenant.

2. What type of work is the ground tenant guaranteeing?

Unlike a standard office or retail lease, obtaining a personal guaranty and/or security deposit from a ground tenant are not common practice on ground leases. However, a personal guaranty from the ground tenant guaranteeing to complete certain capital improvements on the property within a specific timeframe provides the landlord with security. All such work should be outlined in an itemized “Scope of Work” that should be attached as an exhibit to the lease. Furthermore, the more money a tenant spends the more “skin in the game” they have. It is important to note, however, that the amount of money that the ground tenant should spend depends on the condition of the property and the type of property.

3. Has the ground tenant ever defaulted on a ground lease?

A prior default on a ground lease does not necessarily mean that you should not pick that ground tenant. It is more important to find out the reasons for defaulting and how many times they have defaulted. Multiple defaults or defaulting due to overleveraging or inexperience should be considered red flags.

4. How many years has the ground tenant been in business?

Due to the cyclical nature of the real estate market, it is important to pick a ground tenant who has been through it all and survived! However, this should not rule out new companies whose principals have ground leasing experience in their repertoire.

5. Has the ground tenant completed similar projects that you can tour/visit?

Ground leases can be made on all different property types including but not limited to vacant land,

industrial properties, office buildings, residential buildings, and hotels. Therefore, it is important to pick a ground lessee who specializes in the same asset class as your property. It is also helpful to visit and tour the prospective ground lessee's projects in an effort to get a better idea of their craftsmanship and expertise in their execution.

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