Richard Moir
Partner
Tel. +44 (0)7771 812249
rmoir@geraldeve.com

William Ray
Partner
Tel. +44 (0)7944 584105
wray@geraldeve.com

Andrew Matthews
Senior Surveyor
Tel. +44 (0)7919 528183
amatthews@geraldeve.com

AN INTRODUCTION TO LONG LEASE REAL ESTATE – GROUND LEASE, SALE & LEASEBACK AND INCOME STRIP

This is an informative paper providing an introduction to current demand from investors seeking long-dated, secure, index linked rental income allowing owner-occupiers to realise capital from existing freehold or long leasehold property and ensuring a secure, ongoing occupational interest.

We evaluate three principal methods of releasing capital from existing freehold or long leasehold property. The options reviewed can provide alternatives to bank debt or other capital raisings and can be implemented within a circa 3 to 6 months timescale if capital is required.

GERALDEVE

GROUND LEASE

This is basically a low risk 'sale and leaseback', for both occupier and investor, where the purchaser is typically a UK pension fund. It provides the occupier with long term security of tenure; with the potential to recover the freehold for a nominal sum; a low and therefore, sustainable rent; and a high multiple paid by an investor for the rent received. The model is tested and proven for occupiers that require long term occupational security but want to release capital.

Structure and parameters

- Owner occupier sells the freehold (or long leasehold) interest in property to an investor
- Simultaneous leaseback, generally for a term of 100-150 years
- Possible buy-back of the freehold for £1 at say years 50 to 75
- Initial rent generally no more than 25% of market rent and often much lower
- Generally annual or 5 yearly RPI index linked rent reviews (capped and collared)
- Reasonably tenant friendly lease terms to provide operational flexibility [focus is to avoid diminution in the valuation of the Landlord's interest]
- Tenant's funder has cure rights (step-in rights) adding further security for the tenant
- Realise capital from the asset based on 30+ times the agreed rent
- Market value of the freehold investment under the ground lease transaction is often no more than 50% of the market value assuming vacant possession but can be higher
- Best applied to properties with continued use anticipated in the long-term (generally fit for purpose assets in established locations) or possibly, as a means of providing equity into a new development
- For portfolios, property swap provisions can usually be agreed

Issues to note

Occupier / Tenant	Investor
• An attractive funding option for those with weaker credit profiles/covenant strength and a commitment to the property for the foreseeable future • Alternative to bank finance or capital raising • The retained long leasehold interest is suitable for secured lending • The rent is easily budgeted as based on fixed index linked rent reviews • It can be difficult to persuade an existing lender to swap a freehold security for a long leasehold security unless there is competitive leverage The leasehold interest can make future alternative uses more challenging to achieve	• Long lease with rental inflationary indexation • Strong property security with purchase price usually well below vacant possession value • Low risk but low return say 3.0% net initial yield -/+ • Over collateralised position creates annuity type income • Lower risk than traditional real estate investment • The model removes the uncertainty of traditional rent reviews in property investment • Rent sustainability and collection is more certain than traditional sale and leaseback

SALE & LEASEBACK

An established method of releasing capital from property holdings and generally more widely adopted than ground leases or income strips. The occupier would sell the asset to an investor and simultaneously take a lease for a fixed period, generally 15 to 35 years and at a market rent.

Structure and parameters

- The freehold (or long-leasehold) interest in the property is sold to an investor
- Simultaneous leaseback commonly for a 15 to 35 year term
- Can include tenant option to a new lease on expiry
- Initial rent is typically 100% of market rent but particularly for trading activities, can be higher than a vacant possession rent if a business is well established in the premises and operating profitably
- Generally more restrictive lease terms than a ground lease
- Rent reviews can be market based or commonly index linked
- Covenant strength is key to pricing of the investment

Issues to note

Occupier / Tenant	Investor
• Attractive funding option for those with stronger covenant strength • Release more capital from the property asset than a ground lease sale but the multiple of the rent is lower, say 16 to 25 times • Optimise liquidity – debt funding is replaced with a capital sum • The yield/multiplier is determined particularly by asset quality, lease terms and the covenant strength of the tenant / any guarantor • Investors will be interested in the tenant's ability to sustain the rental payments • As the rent is at full market levels, the occupational business is more exposed to challenging periods or downturns in the market • As the rent is generally indexed the property can become over-rented • Can be used to forward fund developments	• Although shorter than a ground lease it still provides long dated, compared with standard commercial leases, and secure rental income • Income security is influenced by the strength of the tenant covenant and underlying value of the asset • Exposure to the property market, benefitting from any long term capital value growth of underlying asset • Contracted rental uplifts provide, often inflation proofed, growth in income

INCOME STRIP

The freehold or long-leasehold property is sold to an investor with an option to buy back the freehold (or long-leasehold) at the end of the leaseback term, typically 30 to 40 years. Most effectively used by government, public sector and quasi public sector bodies, such as universities, with investment grade financial strength, as an option to release capital from property holdings but retain ownership in the longer term.

Structure and parameters

- The freehold (or long-leasehold) interest in the property is sold to an investor
- Simultaneous leaseback for a term of 30 to 40 years
- Initial rent is often say 75% to 100% of market rent
- Rent reviews are generally annual or 5 yearly to RPI (capped and collared)
- The lease is non assignable other than to an Approved Assignee, acting as successor in function to the tenant
- The tenant retains an option to buy back at the end of the lease term for a nominal sum, usually £1

Issues to note

Occupier / Tenant	Investor
• Best suited to tenants with investment grade covenant strength • Can be used to forward fund developments • Pricing is benchmarked to Treasury gilt rates which are currently at historically low levels • Multiples of rent are say 25 to 33 times linked to lease length and tenant covenant strength • Provides access to long-term funding which avoids volatility in short term finance rates	• Secure and long term income • Inflation proofed rental income • Considered 'more bond than asset' • Less impacted by underlying property related and market issues

Disclaimer & Copyright
This document is a short summary and is not intended to be definitive advice. No responsibility can be accepted for loss or damage caused by any reliance on it.

© All rights reserved. The reproduction of the whole or part of this publication is strictly prohibited without permission from Gerald Eve LLP.