

LAND-PURCHASE-LEASEBACK/LEASEHOLD LOAN: AN OLD IDEA WHOSE TIME HAS COME

by James J. Hawk, CRE

It may be an understatement to say that today's cost and shortage of investment capital have adversely affected real estate. How long these conditions will last is anybody's guess. But what do we do in the meantime? It is *not* the American way to respond to challenges with passive indifference. It *is* the American way to improvise and progress.

The Problem

If inflation has increased the cost of investment capital, then uncertainty has in part created the shortage. The conventional sources of capital can't predict the direction or magnitude of inflation and, therefore, will not provide long-term fixed-rate capital in the amounts needed by the market. Instead, these money merchants are slowly and cautiously exploring alternative real estate investment structures while at the same time evaluating the prospects of their long-term role as either a dominant source of capital (life insurance company) or broker and marketeer for a new source of capital (pension funds). Even if the role of life insurance companies does change, the pension funds (corporate, union and government) will not immediately replace the lost investment capital. While pension fund assets are growing geometrically, it has still taken 10 years, from 1970 to 1980, for their commitment to real estate to go from a nominal amount to an estimate of up to 3 percent of their asset base.¹

This means that despite market conditions, developers and institutional investors, whether life insurance companies or pension funds, have an opportunity to

adopt alternative investment structures that can maximize benefits to each other and still develop real estate. One such investment structure is the Land-Purchase-Leaseback/Leasehold Loan or "LPL."

An Alternative Investment Structure

As an approach to creative financing and investing, the Land-Purchase-Leaseback/Leasehold Loan concept has been made manageable with advanced computer technology and comprehensive software programs (one of which is described here) developed and enhanced over the last two major down cycles in the real estate market.

General benefits of the LPL approach vary:

- To the *developer*, greater leverage may be achieved by financing a higher percent, perhaps 100 percent, of the land and development costs.
- To the *investor*, higher overall loan-to-value financing may be achieved and after-tax benefits enhanced in that the ground rent and overage are 100 percent deductible and the leasehold estate is 100 percent depreciable.
- To the *institutional investor/lender*, equity appreciation in fee ownership of the land, stabilized cash flow from the mortgage, and a hedge against inflation through participation in cash flow from ground rent overages and perhaps from appreciation of the leasehold estate may be achieved.

Neither the concept nor economic cycles that reallocate investment capital are new. Technology and reliable software *are* new. The combination of the old concept and new technology in today's economic climate can offer an investment alternative and opportunity to the developer and institutional investor, but not without limitations that are described here.

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Points Of View On The LPL

The LPL approach is ideally created by a single institutional "investor" who buys the land under a proposed or existing project and concurrently commits to make a long-term mortgage loan on the improvements. The other improvements, such as buildings that are built on and subject to a land lease, are called leasehold improvements or leasehold estate. For example, a "developer" could buy a parcel of ground with the expectation of building a shopping center or office building. To induce an investor to provide the necessary investment capital, the developer may choose to sell the land to the investor and enter into a long-term leaseback of the land at a negotiated rental rate plus rental adjustments. Adjustments may be based on various mechanisms, such as an increase commensurate with the increase in the Consumer Price Index or payment by the developer to the investor of a percentage of the project income in excess of a negotiated "floor." Concurrently, with the purchase of the land by the investor and the leaseback of the land by the developer, the investor would make a long-term mortgage loan on the leasehold estate, perhaps based on prevailing market terms and conditions. Upon completion of the foregoing, the investor will own the land in fee as an equity investment and will have leased the land back to the original developer on a long-term basis. Also, the investor will have made a mortgage loan to the same developer at a fixed interest rate and on negotiated terms and conditions. The terms may call for a land repurchase option at fair market value by the developer and perhaps a payoff of the mortgage, both at negotiated intervals. But for practical reasons the mortgage investment must be underwritten so that the unpaid mortgage balance at a call date, if any, does not exceed approximately two-thirds of the project's value excluding land. Otherwise, the developer could have difficulty obtaining new financing elsewhere, especially if the leasehold estate is built on land subject to a nonsubordinated ground lease.

From the developer's point of view the LPL offers an alternative to a joint venture, an equity/debt combination, a convertible mortgage, or a straight equity participation. Several of these structures can minimize after-tax yields for the developer or ultimate buyer. The severity of the reduced after-tax yields in some cases may even make the legal documentation of the LPL structure tolerable.

The LPL combines two separate and distinct investments: 1) the investment in the land; and 2) the investment in the mortgage. Each investment stipulates a minimum land rent or mortgage payment. In the case of the land ownership, a mechanism by which additional ground rent is paid as an overage can be provided for in the ground lease. This structure is designed to achieve three distinct investment objectives: 1) an equity investment that can appreciate and provide a hedge against inflation; 2) a mortgage in-

vestment that can stabilize the portfolio yield as well as generate a return of capital that can be reemployed at prevailing market rates; and 3) a cash flow that is also a hedge against inflation and a compounding mechanism to help an investor's portfolio grow. The first objective can include the investor's participation in the appreciation of the residual value of the improvements. However, cash-flow-conscious investors in an inflationary climate may elect to increase their overage participation rather than speculate on longer term potential appreciation of the leasehold improvements.

Underwriting

The general mechanics by which the investment in the land and mortgage are made are as follows: the investor purchases the land for the developer's cost plus reasonable off-site and holding costs or fair market value. (It is desirable to consult with a tax advisor concerning the tax impact of a purchase at fair market value.) The minimum ground rent that the developer pays to the investor under the terms of the ground lease will be a negotiated percent of the total amount funded by the investor for the land. As a ground rent overage paid in addition to the minimum ground rent, the developer would be obligated to pay a percentage of the completed project's income in excess of a negotiated floor. The floor can be based on an estimate of adjusted gross income, defined net income or defined spendable cash flow. The percentage of the project income that is paid as an overage is negotiable and usually based on a variety of factors including the level of minimum rent and whether it is a facilitating minimum that is below the prevailing market for comparable investments. Another factor is that a mortgage investment can be underwritten conservatively, or if the investor is an aggressive investor, the amount loaned can be what is described as a "full loan." After the analysis and evaluation of an investment pro forma and determination of a satisfactory net income, the loan amount, rate and terms become a function of the loan-to-value ratio, capitalization rate and the required debt-service coverage. These can be varied individually in order to produce a higher or lower indicated loan amount. Usually the underwriting criteria of a mortgage on a leasehold estate wherein the landowner and lender (mortgagee) are one and the same will be similar to the underwriting criteria of a conventional mortgage loan. The investment criteria for a mortgage loan on a leasehold estate are more rigid when the land is owned by a third party (for example, not the developer or investor) and the mortgage loan is subordinated to the ground lease.

Overage Calculation

The mechanics by which the ground rent overage percentage is determined are usually a function of the investor's initial yield objectives. Once that objective is achieved, a secondary overage percentage

is based upon arbitrary negotiations between the investor and developer. For example, the investor buys the land, enters into a ground lease and requires a minimum return of 10 percent on the land purchase price. In return for a favorable initial rate of return on the land price (10 percent) by comparison to the prevailing market, and/or in return for advancing a generous land purchase price and mortgage loan which combined may equal 80 to 100 percent of the total development cost including the land cost, the investor may require 50 percent of the project income in excess of a negotiated floor. For example, when the combined cash-on-cash rate of return equals 12 percent, after dividing the minimum ground rent, ground overage payment and mortgage interest by the land cost and unpaid mortgage balance, the percentage of project income in excess of the negotiated floor may be reduced to 25 percent which reduces the rate of accelerating yield that the investor will recognize. The reverse philosophy can be employed if the investor wants to lessen the burden on the cash flow during the earlier phases of a new project. In either situation an investor may have a minimum internal rate of return (IRR) requirement, in which case how the investor structures

his participation will affect the targeted IRR in, for example, an assumed 10-year holding period.

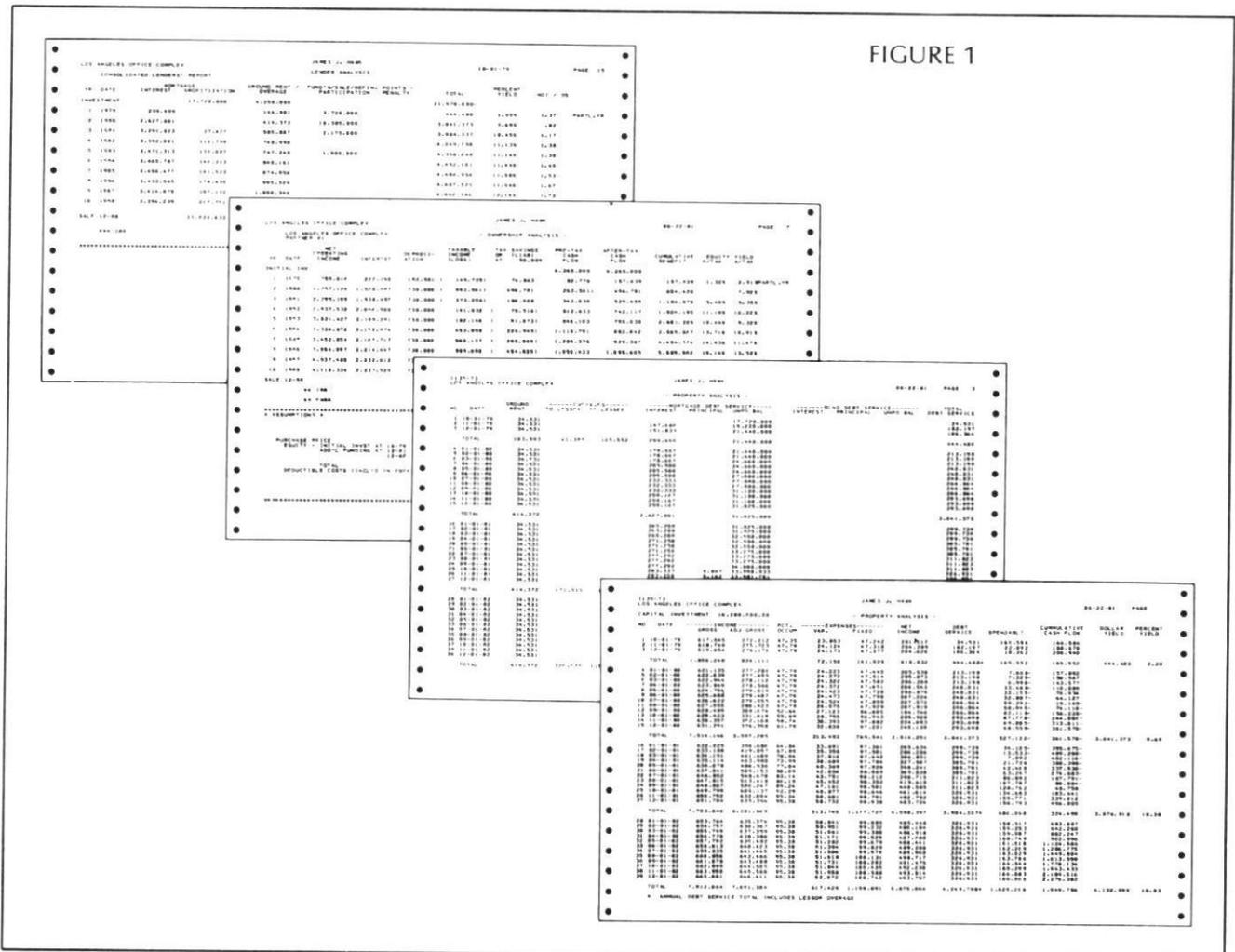
The Elements Are The Same

An LPL structure uses the same fundamental underwriting assumptions as conventional investment structures, that is, debt-service coverage, loan constant, holding period and resale value of the asset, inflation rate(s), and investor share of the operating cash flow and residual value of the asset upon sale, etc., but they are melded and determine the burden on the property and/or return to the investors. The principal formula is to return to the investor a minimum yield on the mortgage and ground lease and a share of the upside if the project is successful; and to return to the developer maximum leverage and his share of the upside if the project is successful.

Computer Technology And An Old Idea

Again, the LPL concept is not new but is now a manageable concept. Time-consuming manual calculations and broad approximations of cash flow and yields are unnecessary. Instead the LPL concept is made manageable, fast and accurate by an analytical software program that produces the examples below.

FIGURE 1



The report simulates a project's cash flow before and after payments for debt service, ground rent, and ground-rent overages, and will translate those cash flows into accurate pre-tax and after-tax cash-on-cash and IRR yields for either the institutional investor who owns the land and has made the mortgage loan on the leasehold estate, or the investor/developer who owns the leasehold estate.

The report consists of three parts: 1) Property Analysis; 2) Ownership Analysis; and 3) Lender (Investor) Analysis.

On the first page of the Property Analysis, the last two columns to the right indicate a dollar and percent yield on the institutional investor's land purchase investment and mortgage investment. The return of principal or amortization is not included in these yields. The initial annual yields are low because they are either partial years or maximum occupancy has not been achieved. Reporting a consolidated yield as in this report is for convenience only and is not intended to indicate that the land purchase and mortgage are melded, thereby creating a financing vehicle in the eyes of usury states. The ground rent and mortgage payments including principal and interest should be paid separately to the investor, as provided for in the respective documents. The Ownership Analysis is available for a single ownership entity or up to 10 partners. The Lender Analysis consolidates the return on a cash-on-cash basis and a 10-year rate-of-return basis for a conventional lender(s) or an institutional investor, using a mortgage participation or an LPL structure. The amortization is included in the IRR calculation in this report. All investment structures work with the same elements, that is, cash flow, residual, and tax benefits or liabilities. They differ in timing, emphasis and combination of each of the elements.

The program² that produces the sample figures is not a substitute for sound judgment and underwriting — it merely helps optimize the right combination of these elements for the particular needs of the parties involved.

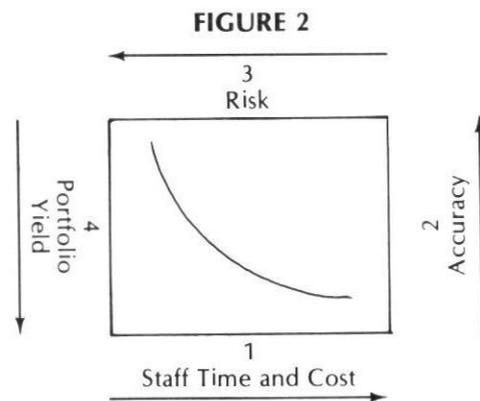
This decision-making tool is employed using the investor's assumptions which are easy to input and offer broad latitude to simulate the most subtle refinements of manual real estate underwriting techniques. The manageability of the LPL approach, as provided by the computer program, enables the investor to be fast, accurate and competitive in evaluating prospective investments, and such criteria are necessary to attract quality investments.

The disadvantage(s) of the LPL approach, in some states, is the issue of usury; and in all states, the complexity of the legal documentation. Pension funds and life insurance companies, both inside and outside California, employ the LPL concept but many have withheld using it because of usury and/or the complex, time-consuming undertaking that is re-

quired to underwrite the investment if the computer program or similar technology is not employed. The fundamental disadvantage of the LPL concept is that the developer by selling the land and paying a ground-rent overage gives up a portion of the project income that would otherwise contribute to the economic value of the property, if and when the project is sold. Usually, the LPL concept is not employed because of the foregoing reasons. But when high interest rate markets prevail and/or a shortage of investment capital develops, the concept becomes attractive to both the developer and investor: to the developer because he wants the increased leverage or cannot find the necessary money without offering a "kicker;" to the investor because he wants the hedge against what he perceives as the devaluing effect of inflation.

Conclusion

The LPL concept in today's market is a viable investment structure and has been made fast, accurate and manageable to underwrite with computer technology and reliable software. The following linear curve diagram best illustrates the advantages of computer technology and a reliable software program.



Perhaps the most important prerequisites of any software are that it be reliable, compact and readable, flexible, and relevant to the objectives of the user.

Technology has overtaken the real estate profession and technical problems do exist for the practitioner, but today's capital-need problems all but demand initiative and resourceful thinking. For some, the Land-Purchase-Leaseback/Leasehold Loan investment structure, made manageable with technology and reliable software, can solve some otherwise insoluble problems.

NOTES

1. Money Market Directories, June 1981.
2. "ComA," Copyright James J. Hawk, 1978.