

# How Long Is a Long-Term Lease?

by Roy P. Drachman, CRE

If a man doesn't learn anything during nearly 50 years of experience in the real estate business, he was either extremely knowledgeable at the beginning or too dumb to recognize the important facts he encountered along his lengthy journey.

I fall into the latter group. I have learned many, many things as I wended my way through a melange of real estate deals that included shopping centers of all sizes, office buildings, residential developments and industrial projects.

One thing I learned early on was that if you had no capital but a good idea, for a shopping center, for example, about the only way to put the package together was to find a property that could be leased with the right of first mortgage to provide funds for construction.

Another thing I learned was that it was not difficult to find such properties and owners who would permit that kind of arrangement for financing a project. I will not bore you with the techniques used to make such deals. That story has been told many times by many people.

The most important thing I have learned about leasing the land on which a development will be placed concerns the length of the lease term. I, and many other developers, have long believed that a 50- or 60-year lease was long enough to accomplish almost any kind of development.

"Why not?," the thinking has been. "I'll be 85 or 90 years old by the time the lease runs out, and I won't care after that. Furthermore, all the buildings will be worn out by then anyway," the dialogue continued.

Well, let me tell you how wrong we who have thought and acted that way were. I am one of those 85-year-old guys who is now aware of having made a gross error.

A partner and I leased a parcel of land on which we built a neighborhood strip center of 100,000 square feet. We had the right to encumber the land on a first mortgage which provided all the money needed to cover development costs.

The length of the land lease was 60 years, which certainly seemed long enough to us at the time. The length of the mortgage was 20 years. The shopping center opened in March of 1957. My age at that time was 50. I believe that almost anyone consulted at that time would have agreed that my partner and I had made a good deal.

The shopping center was a success from the time it opened. We paid off the mortgage in 20 years

and held the property free and clear. The income from the development has been acceptable and steady. We remodeled the center a few years ago and have been attentive regarding the maintenance of the property. As a result, it has been quite productive.

Competition has emerged in the form of other shopping centers in the trading area, but it has not seriously affected the volumes that our tenants enjoy, and there has been practically no decrease in the amount of rent we collect.

So, one might say: "What problem do you have? What is wrong with what has happened to that property?" Obviously, the answer is: "Nothing seriously is wrong with the property; but the problem is with the ground lease that was negotiated in 1956 and will terminate in 2016." We have only 24 years left on the ground lease. At that time, the ownership of the buildings will revert to the owner of the land.

Our key tenant, one of the large food chains, occupies a store of approximately 25,000 square feet in our shopping center and wants us to increase the size of the store to 40,000 or 50,000 square feet to make it more competitive with the other new supermarkets in this area that have 40,000 to 50,000 square feet.

We can either ignore the request of our present tenant, whose lease has just a few years before it expires, or face the prospect of increasing the size of the store to suit the tenant for the relatively short period of 24 years.

Financing today, under the best of conditions, is not easy to obtain. Even under what might be called normal conditions, would it be wise to build a new building knowing that we will have to give it away in 24 years? Furthermore, our tenant may not accept a lease with such a short term.

I have had some experience with other ground leases that ran 50 or 60 years. While I sold my position in these properties, I continue to think about what must be happening to the present owners. I must come to the conclusion that a 50- or even 60-year lease is hardly long enough; the lessee must have some option to extend the lease to somewhere around 90 to 100 years.

The years slip by very quickly, and when you reach my age, you can look back and see very clearly that a long-term investment that pays good returns is a very valuable asset. It is one that you do not wish to give up but may be forced

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to because the title of the buildings will flow to another owner when the lease term for the ground is not long enough.

As for the buildings wearing out, that can happen, of course. But, on the other hand, a going business can operate in a very old building for a very long time, as many of us can attest.

So, a bit of free advice from someone who has made the journey over the hills and through the valleys: If you must make a lease that has no more than 50 or 60 years for its term, be sure to have the option to extend the actual term of control of the land to 90 or 100 years.

I have been told that in England it is not unusual for lease terms to be for 1000 years; I heard of one lease for 2000 years. I do not think anyone would have the temerity to project a value for property that many years ahead. But at least the developer of the property will own something he can pass on to his grandchildren, and they to theirs.