Unearthing Commercial Ground Rent Financings

The real estate market is constantly evolving, and with it, the ways in which property ownership is financed. One structure that is increasingly gaining traction is commercial ground rent financings – but what exactly is a commercial ground rent financing, and how does it compare against a traditional loan secured against commercial real estate and indeed against more traditional sale and leaseback arrangements?

1. What is a commercial ground rent financing in a nutshell?

At its core, a commercial ground rent financing (a "**CGRF**") is a financial structure whereby a capital sum is provided by an investor to the owner of a property; in return, the property is transferred to the investor, and a lease is granted to the (now previous) owner of the property, with the lessee agreeing to pay ground rent to the new owner. As such, a CGRF allows a property owner to raise capital from a property whilst being able to remain in occupation of, and operate from, the property – and the investor benefits from a stable, inflation-linked income stream throughout the lifetime of the lease.

Notwithstanding the "financing" label, CGRFs are, in fact, a creature of land law – and so it's all about the transfer of the real property and the grant of the lease (as opposed to the entry into a suite of finance documents, as would be the case with a traditional debt finance transaction).

CGRFs should not be confused with residential ground rent, which has separately been the subject of recent intense political debate and proposed legislation – the two are very different.

2. How does a CGRF work in practice?

Much like a traditional sale and leaseback real estate transaction (whereby the owner of a property sells the property to a third party, and then takes a leaseback which allows it to continue occupying the property), a CGRF is achieved by:

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(a) **the property owner (say, a freeholder) of a parcel of land (the "Property") releasing the Property's value through the sale of the Property to a third-party investor/purchaser (who makes an upfront capital payment to the Property owner in return for the transfer of the freehold interest in the Property).** Looking at this through a finance lens, this results in the "lender" (being the investor/purchaser) paying the "loan amount" (being the purchase price for the Property) to the "borrower" (being the Property owner/seller) on the transfer of the Property by the "borrower" to the "lender" – thereby allowing the Property owner/seller to unlock capital and gain liquidity; and

(b) **the investor/purchaser simultaneously granting a lease of the Property to the seller.** Pursuant to the terms of the lease, the seller (as tenant) is: (i) required to pay to the investor/purchaser a rent; and (ii) entitled to remain in occupation of the Property for the duration of the lease. Again, applying the finance lens to this, the borrower's "repayments" (in terms of principal and interest) are made to the "lender" in the form of rent payable under the terms of the lease; and

(c) in most cases, **the seller being granted an option to buy back the freehold interest in the Property from the investor/purchaser at the end of the term of the lease for a nominal sum.** From a finance perspective, this would be at the point at which the "loan" matures and is repaid.

From the perspective of a property owner, CGRFs can therefore be compared to taking out a loan secured against real estate which is repaid over time: the initial capital sum (or "loan") it receives via the sale of the Property is gradually paid back (with interest) to the investor/"lender" via the rental payments under the lease, mirroring the structure of principal and interest repayments under a loan. And, from the vantage point of an investor, CGRFs are (as a result of the steady income stream payable under the lease) generally viewed as being akin to long-term bonds that are linked to inflation (although CGRFs are, naturally, more illiquid in nature).

3. This all sounds very much like a traditional sale and leaseback transaction. What is the difference between that and a CGRF?

Whilst the kinship between CGRFs and sale and leaseback transactions may seem close, they actually tread on very different ground: it's best to think of them as being like cousins, as opposed to identical twins.

In a traditional sale and leaseback transaction, a property owner sells its property to a buyer and then takes a leaseback from the buyer (thereby allowing it to continue to occupy the property as a tenant). This frees the capital tied up in the property, which can then be put to use elsewhere in the business. So far, so similar. However, there are three key differences between traditional sale and leaseback transactions and CGRFs:

(a) **Ownership of property post "transaction":** A sale and leaseback transaction involves the property owner selling the property outright to an investor/purchaser, and therefore losing ownership (unless the seller/tenant benefits from a buy-back option – although this will generally be for a market sum). In a CGRF arrangement, however, the tenant of the Property (i.e. the original owner of the Property) typically retains the ability to reacquire the freehold interest at the end of the term of the lease – in most cases, this will be for a nominal sum (of, say, £1) – such that it will enjoy the benefit of any future appreciation in the Property's value. It is for this reason that a CGRF is more akin to a financing than a sale: at the end of the term of the lease, the "lender" (i.e. the investor/landlord) has been repaid the "loan" (being the purchase price under the original sale) plus interest (being the rent payable under the lease), and is therefore happy to transfer the Property back to the original Property owner for a nominal sum before it then walks away.

(b) **Rent (open market vs index linked):** The initial rent payable under a lease which is granted pursuant to a traditional sale and leaseback will typically be an open-market rent (which will then be subject to regular open-market rent reviews throughout the term of the lease).

However, under a CGRF, the initial rent payable under the lease will be calculated based on the earnings of the tenant's business (typically, a percentage of earnings before interest, tax, depreciation and amortisation (EBITDA) – rather than the current market rent). The rent under a CGRF lease will then increase annually on an inflation-linked basis (for example, the rent may be tied to the Retail Prices Index or the Consumer Prices Index), with a cap and collar so as to provide certainty for the parties.

(c) **Term (CGRF typically far longer):** A lease granted under a traditional sale and leaseback transaction will usually be for a term of around 20-30 years whereas CGRF leases tend to be granted for a term of anywhere between 100 and 250 years. Aside from this resulting in a secure, reliable and long-term income stream for the landlord (which is viewed very favourably by insurers and pension funds, for example), and affording the tenant under a CGRF lease an ability to continue operating its business from the Property on a long-term basis (invariably with fewer operational restrictions), the majority of the value in the Property is retained by the tenant (thereby allowing the CGRF lease to still be used as first ranking security by third-party lenders in a traditional real estate debt financing).

4. How does a CGRF stack up against a traditional loan financing secured by a legal mortgage against a property?

Let's now juxtapose a CGRF with the more traditional loan financing secured by a legal mortgage against a property – the bedrock of property financing for decades. In this very familiar structure, a lender provides a loan to the property owner who, in return, grants the lender security over the property. If the borrower defaults, the lender can take enforcement action (including selling the property to a third party) to recoup the outstanding loan amount.

CGRFs present a seismic shift when compared against this landscape. Unlike traditional loans:

(a) the capital sum released from the one-off sale of the Property (see paragraph 2(a) above) is permanent (which means that the "borrower" does not need to be concerned with any refinancing risks that come with a traditional loan) and, whilst there is rent to pay under the lease, there is no debt to service (such that the "borrower" does not need to be concerned about interest rate fluctuations); and

(b) as a CGRF is not a loan, banking regulations do not apply, and the CGRF does not appear on the tenant's/"borrower"'s balance sheet as a debt (and, therefore, a CGRF can be an attractive prospect for landowners looking to maintain certain financial ratios); and

(c) there is no security package which is provided to the "lender" – and nor is one required. This is because the landlord/"lender" already has "security" by virtue of its ownership of the freehold title to the Property and the terms of the lease – such that, if the tenant/"borrower" commits (say) a material breach of the terms of the lease then, subject to the terms of the lease, the landlord/"lender" could take steps to forfeit the lease thereby terminating the tenant's/"borrower"'s interest in the Property; and

(d) it is worth noting that on enforcement of a legal mortgage against a property to secure a loan, the borrower would be entitled to be paid any excess recovered over the debt amount. This is not the case with a CGRF – the landlord/"lender" forfeits the lease for non-payment and retains the full value of the unencumbered Property, even if that exceeds the expected value of the ground rent. This creates a very strong incentive for the "borrower" and any lender with security over the leasehold interest to ensure that the ground rent is always paid.

Needless to say, CGRFs and traditional real estate loans each still have their unique place in the ecosystem of financial strategies. Indeed, comparing CGRF to a traditional real estate financing is a bit like comparing a tailored suit to a ready-to-wear garment; both serve a similar purpose but in different ways and for different occasions. Whilst CGRF offers a unique set of benefits, it's not a one-size-fits-all solution that will replace or overshadow traditional real estate financing. Traditional loans will continue to play a vital role for many property owners who may prefer or require direct, often shorter-term, and more agile/flexible borrowing solutions; CGRFs, on the other hand, are more beneficial for those looking for slow-and-steady, long-term, stable and foundational investment structures. And they're not mutually exclusive either: as noted in paragraph 3(c) above, one of the key advantages of a CGRF is that it can be used as a complementary product alongside traditional real estate financing options.

5. Navigating the terrain – key points to bear in mind

Although CGRFs can offer a solid foundation for a financial restructuring, they are not without their pitfalls. For one, property owners must grapple with the long-term commitment of paying ground rent which, although typically low, remains a constant financial commitment that can span generations. This could mean a trade-off: immediate capital at the expense of an enduring obligation.

The investor/“lender” will become both a property owner and a landlord, and will therefore be subject to all relevant laws and regulations in that capacity. In addition, the investor’s interest in the Property will require registration at HM Land Registry – and, if the investor is an overseas entity, it will need to register on the Register of Overseas Entities (see our Talking Points Article).

If there is existing debt secured against the Property which is to be subject to the CGRF then that will need to be considered, alongside early tax structuring to plan for any available reliefs from stamp duty land tax. With IFRS having brought operating leases onto a tenant’s balance sheet, it will also be important to assess the accounting treatment that the lease will be given – and how that might affect the tenant’s wider reporting or compliance with existing financial covenants.

Whilst the market for CGRFs was at a relatively embryonic stage only a few years ago, with a relatively limited number of investors (principally comprising pension funds and insurance companies), CGRF structures have been steadily growing in popularity with both new and different types of investors entering the market. If you would like to discuss CGRFs in more detail, please do get in touch.

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