Land FOR Lease

With leasehold interest, your clients can successfully develop on property they don't own

By **Phil Sblendorio**, senior vice president and regional business manager, Farmers & Merchants Bank

YOUR CLIENTS HAVE AN EYE ON a piece of undeveloped land that would be a terrific location for a shopping center. Unfortunately, the landowner is not willing to sell. A possible solution? A long-term land lease. The question then becomes: How do you finance development on leased land?

With today's high cost of land, obtaining a leasehold interest in a property is an alternative method for temporarily acquiring control of property on which to build. Lending on leasehold interest is becoming increasingly common.

What is a leasehold interest?

A leasehold is an interest in real property in which the leaseholder possesses a long-term lease to use a property owned by someone else. The lease usually gives the holder the right to construct, lease and manage buildings on the property.

Lenders who lend on leasehold interest are providing financing based on the value of the leasehold deed of trust. The leasehold itself is the only real collateral on the loan. Essentially, your clients are borrowing money to build on property that they don't own.

Four key steps

Deals of this sort can get complicated. Your clients will need to do their homework and get their ducks in a row before you begin to package the loan. It is necessary to:

- **Conduct a feasibility study.** The deal's profitability must be excellent; if it's a tight deal, it will be difficult, if not impossible, to obtain loan approval. You and your clients must answer the following questions:
  - What is the property's zoning? If it is not zoned for your clients' proposed use, what are the cost, timing and feasibility of getting it rezoned?
  - What are the estimated land-lease payments, construction costs (including interest reserve), tenant improvements, leasing costs and loan payments?
  - What will be the estimated maintenance and management costs?
  - How much rent income will the project generate?
  - What will be the estimated monthly profit for the project?

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- **Negotiate with the landowner.** All details of the land lease must be worked out. The lease should be for a minimum 50-year term, as most lenders won't touch a deal like this unless the lease runs at least 15 to 20 years past the loan's amortization. The agreement needs to: spell out the monthly lease payments and any provisions for payment increases; specify that your clients have the right to develop the property; and clearly state whether ownership of any improvements made to the property will revert to the landowner at the end of the lease term.
- **Negotiate with potential tenants.** Before approving a loan, the lender will want proof that there is demand for the project. Your clients should start looking for anchor and in-line tenants and looking to obtain letters of intent from those who are interested.
- **Ensure that all parties will sign nondisturbance agreements once the project receives the green light.** A nondisturbance is a legally binding agreement. It says that in the event of foreclosure, the tenants will not be disturbed — as long as they pay rent and otherwise perform according to the lease terms.

A deal of this nature involves many parties — the landowner, the landowner's lender (if the landowner has an outstanding loan against the property), the leaseholder, the leaseholder's lender and the tenants — each of whom can be at risk if one of the other parties does not honor its obligations. The nondisturbance protects each of these parties.

If the landowner has an outstanding loan against the property, for example, your client's lender will want to be protected in case the landowner's lender (which holds the first-trust deed on the property) files a foreclosure and notice of default — and terminates the lease. Because your client's lender will be granting a loan based entirely on a leasehold interest in the property, it will want assurance that the terms won't change. It will therefore insist that both the landowner and the landowner's lender agree to sign a nondisturbance agreement. The agreement is contingent upon your client making his agreed-upon land lease payments. Further, the agreement will make your client's loan senior to the landowner's loan.

On the other side of the deal, a major tenant may worry that if your clients' loan goes into default and your clients' lender forecloses, the tenant's long-term lease could be wiped out. The potential tenants don't want to worry about the possibility of losing their leases just because others don't make their payments. The tenants' only protection is to have everyone sign a Subordination, Nondisturbance and Attornment Agreement and an Estoppel Certificate.

Working together

One of the biggest challenges can be getting all parties to realize that it's in their best interests to work together. In the best-case scenario, the deal results in a successful development in which each of the players — lender, landowner, developer and tenants — happily makes money. In the worst-case scenario, an entire deal can unravel because someone refuses to sign a nondisturbance agreement.

To look at how this would work, let's take Kevin's situation. For the past six months, Kevin has been trying to purchase a five-acre parcel of raw land from Steve worth $2 million. The land has been in Steve's family for many years, however, and he is not willing to sell. Kevin has now negotiated a 50-year land lease for this site for $3,000 per month. He has received permission to develop the land and has obtained commitments that nondisturbances will be signed.

Kevin plans to construct a 55,000-square foot shopping center on the land, with the remaining land to be used for parking and landscaping. Construction costs are estimated at $6,875,000. Kevin has no cash and will need to borrow the full construction cost. The monthly payments on a 30-year loan at 6.5 percent will be $43,454. Kevin estimates that once the center is built, he can get an average of $1.75 per square foot per month in rent income, all in triple-net leases.

His estimated total rent income will therefore be $96,250 per month. Kevin also estimates that his maintenance and management expenses will be approximately 10 percent of his lease income, or $9,625 per month.

Kevin calculates the project's estimated profitability by taking the $96,250 estimated rent income and subtracting $56,079 in total estimated expenses ($43,454 mortgage payments, plus $9,625 maintenance and management, plus $3,000 ground lease payments). The result: a positive cash flow of $40,171 per month.

Armed with the good news that the project is doable, Kevin finalizes the land lease, starts to line up tenants and gets everything in order so he can obtain financing.

Packaging the deal

A loan package for a leasehold interest loan should include:

- **Ground-lease documentation**, with all the provisions necessary for all of the subsequent leases, loans and nondisturbances;
- **Construction cost breakdown;**
- **Estimated cost of tenant improvements;**
- **Future profit-and-loss statement**, including expected rents and hypothetical tenants; again, letters of intent are helpful here; and
- **Typical loan documentation**, including preliminary title report on the land, information on existing loans against the land, approvals from the city, a Phase I environmental site assessment and possibly a Phase II if anything turns up on the Phase I.

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In today's extraordinarily expensive real estate environment, developing on leasehold land can be a smart way to build a successful project. It is critical, though, to understand the projected cash flow of the venture and to know how to package the deal to obtain the necessary funding.

If you follow the steps outlined herein, chances are the deal will be a win-win for everybody.