SLATT CAPITAL

LAND/GROUND LEASE

Business owners who want to expand operations have two choices for securing land. They can buy a piece of raw land and build from the ground up the exact structures they need to run the business, or they can lease it from a landowner. Although buying a property outright gives the business owner complete control over the project, it also requires them to expend capital that may be better used in a different capacity. For this reason, leasing is an attractive option, but it can limit the scope of the expansion project depending on what the landowner allows on the property.

A land lease can be a beneficial arrangement for some business owners. Because it gives them a degree of control over what happens on the property, they can build and manage the structures they need. This type of agreement also benefits landowners who gain from the improvements made to their property without expending their own time or money. For this reason, land leasing has been popular in the United States. From 2018 to 2023, the land leasing industry grew faster than the overall real estate and rental leasing sector, reaching a market size of $17.7 billion in 2023.

This paper explains how a land lease works and explores the benefits and risks it poses for tenants and landlords.

What is a Land Lease?

A land lease—also called a ground lease—is an arrangement between a land owner and tenant that allows the tenant to make improvements on the property during the lease period, which typically runs from 50 to 99 years. However, some land leases can be structured for shorter terms. This type of lease is common for commercial properties, and companies like McDonald's, Starbucks, and Whole Foods use land leases to secure prime locations for their restaurants and stores.

Under a land lease, the tenant doesn't own the land but usually has the right to construct or renovate buildings on the property at its own expense. At the end of the lease period, the land and all improvements return to the owner. To avoid confusion about ownership, the lease defines precisely who owns the land, what the tenant can do to the property, and who owns the rights to the improvements made by the tenant. Additional terms included in the lease agreement are property maintenance, default conditions, and financing options.

Types of Land Leases

Subordinated Land Lease

In a subordinated land lease, the property owner essentially lets the tenant use the land as collateral for the loan. Although the loan is in the tenant's name, the lender can take possession of the land if the tenant defaults on the loan. Having a subordinated lease can increase the tenant's approval odds since the lender assumes less risk.

Landlords who agree to a subordinated land lease can often negotiate higher lease payments since they risk losing their property. However, landlords also recognize the value added by the construction on the property. If they choose to sell the property at the end of the lease term, they can cash in the equity and realize significant gains on the property without being responsible for making the improvements directly.

Unsubordinated Land Lease

In an unsubordinated lease, the landlord retains top priority, so the lender is unable to take the property in a foreclosure prompted by the tenant's default. This arrangement protects the landowner's interests, but it increases the lender's risk. As such, tenants may not be able to secure financing for their projects, and the loans they do qualify for may have less than desirable terms.

Tenants often have more negotiating power with an unsubordinated land lease. The landlord still wants to benefit from the improvements the tenant makes and will typically offer a lower rent to compensate the tenant for the financing challenges.

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How Land Leases Work

Land lease terms will vary depending on factors like the property's location, the nature of the business, and the value of the planned improvements. However, the lease agreement typically details what the tenant is allowed to do on the property and what they will pay. This includes monthly rent, property taxes, utility expenses, and maintenance costs. In most cases, the tenant is responsible for all financing costs and insurance.

Consider the following example of a fictional tenant, Happy Foods Enterprises, which plans to open new stores and needs more warehouse space to keep the stores stocked. The leadership team found the ideal piece of property for the new warehouse. It's within a 20-minute drive of the corporate offices and fewer than five miles from the interstate. Happy Foods has the cash on hand to buy the property, but the company doesn't want to lock up all of its money in the raw land.

Happy Foods negotiates with the property owner to lease the land for 35 years with the understanding that it will build a warehouse on the site. The grocery store chain will take out a loan to pay for the construction and will cover the property taxes and insurance. The landowner agrees to the arrangement and lets Happy Foods build the warehouse it wants without interference, knowing the property is in a prime location for a warehouse. Finding a new tenant if Happy Foods moves out should be no problem because any tenant needing warehouse space will benefit from the location. The property owner will collect the monthly rent check until the end of the lease.

Pros and Cons for Tenants

One of the greatest benefits a land lease offers tenants is the ability to use property they may otherwise be unable to afford. Properties with easy access to highways, plentiful parking spaces, and proximity to public transportation usually come with a higher price tag. Through a land lease, the tenant gets the location they want without spending the money to purchase it.

That's not the only benefit of a land lease. It also comes with the following advantages for tenants:

- Business owners don't need to come up with a large down payment.
- The company has more money available for other purposes.
- Businesses that cannot qualify for a mortgage may be able to build the facilities they need without borrowing money.
- The company may be able to lower its tax burden through tax deductions.

The downside to a land lease is the fact that someone else owns the property and has the final say about what can and cannot be done there. Sometimes the tenant has to wait weeks or months to get approval for a specific project on the site even though they are increasing the property value. Over time, the cost of the lease may exceed the cost of purchasing the property.

Pros and Cons for Landlords

Landlords like land leasing because it brings them a steady income with minimal effort. In exchange for using the property, the tenant pays to construct buildings, install utilities, set up parking lots, and more. Ideally, the tenant's improvements increase the value of the property so the landlord makes even more money when it's time to sell or lease to a new tenant. Some landlords include escalation clauses in the lease that allows for regular rent increases, the right to evict the tenant, or landlord approval for all changes to the land.

In some cases, a land lease is a detriment to the landlord. The lease may contain language that gives the tenants more rights than the owner or lack a clause that protects the landlord's interest in the property. For example, the landlord can lose the property if they agreed to a subordinated lease and the tenant defaulted on the loan. Some landlords pay higher taxes as a direct result of the land lease, as rent considered income is taxed at the ordinary tax rate.

When Does a Land Lease Make Sense?

It's easy to see the benefits of a land lease for a landlord—especially if they agree to an unsubordinated lease that doesn't put the land at risk. Understanding why someone would pay to improve another person's property can be more challenging. However, there are times when it makes sense for someone to build on land they don't own. The following scenarios highlight the benefits of land leases for tenants:

- A farmer or rancher needs more space to grow crops or let cattle graze but doesn't want to purchase the large tract of land required.
- A corporate office purchases land to lease to a franchisee who assumes responsibility for constructing the building for the new location.
- An oil company wants to drill for oil on a piece of property located far away from the rest of its land holdings.
- A company needs to move soon and doesn't have time to go through the underwriting process to get a loan and purchase property.
- A property developer wants to construct a commercial park but doesn't want to tie up all of the capital for the project in the land.
- A landowner wants to develop a piece of vacant land but doesn't have the time or resources to design and build it.

In these situations, the land lease solves a problem for the tenant or landlord. All parties have a chance to use the land to create facilities they can use that will also be useful for someone else in the future.

When considering financing for commercial real estate development projects, it's helpful to work with a professional who can help you understand the available options. The team at Slatt Capital has a proven record of building relationships with clients and matching them with the right capital solution for their business needs.