

WATSON FARLEY & WILLIAMS

BRIEFING

GROUND RENT TRANSACTIONS IN COMMERCIAL REAL ESTATE SEPTEMBER 2018

- GROUND RENT TRANSACTIONS EXPLAINED
- A LONG-TERM, PREDICTABLE INCOME STREAM
- LIKELY LOWER DEFAULT RISK WITH QUALITY SECURITY



“A GROUND RENT TRANSACTION ALLOWS COMPANIES TO UNLOCK VALUE FROM THEIR REAL ESTATE WHILE CONTINUING TO OCCUPY AND USE IT.”

What is a ground rent transaction?

A ground rent transaction is a type of financing under which a company can release a capital sum by selling and leasing back its real estate (with an option or other mechanism to reacquire the real estate for a nominal sum at the back end of the transaction).

These transactions are becoming increasingly common, particularly in the hotel, student accommodation and care sectors. They are, typically, long-term with leases running from 99 years to, say, 200 years.

Economically, they are essentially amortising secured loans: the company gets an upfront advance and the rentals it pays are akin to principal repayments with interest. The capital sum received in consideration of the sale reflects the net present value of the rentals over the term of the lease – so setting the rentals higher can create a larger capital sum. And the rentals can be index-linked (perhaps with a collar).

Why would a real estate owner do a ground rent transaction?

A ground rent transaction allows companies to unlock value from their real estate while continuing to occupy and use it. The rents are set at affordable levels and banks are generally willing to lend (or continue to lend) in parallel to the ground rent as long as the rentals do not eat too far into EBITDA.

The company will swap a freehold asset for a leasehold asset – but that does not (at least so far as bank models are concerned) necessarily significantly reduce the value of the company's assets because, while the leasehold asset is not permanent, it is, by

“THE BENEFIT FOR AN INVESTOR IS A SECURED AND PREDICTABLE LONG-TERM INDEXED INCOME STREAM.”

any measure, long-term (including as compared to senior debt tenor). Further, the covenant package for a long lease is generally significantly lighter than for senior debt.

Why would an investor do a ground rent transaction?

The benefit for an investor is a secured and predictable long-term indexed income stream. That suits pension funds and others with long-dated liabilities well as it allows them to match liabilities with index-linked assets at higher yields than other asset classes such as bonds.

Defaults are thought to be comparatively rare because, first, loss of the lease would, for a company that relies on the real estate to run its business, be disastrous and, secondly, the rentals are affordable and "super senior" to other financial liabilities.

Given the pricing structure, the value of the real estate (which is essentially security) will normally significantly exceed the value of the unpaid rentals (particularly if the real estate market rises over the long term of the lease): that should give an investor significant comfort that a default would be more than adequately collateralised.

Tax treatment for real estate owners

There are a number of tax points to consider.

Most importantly, the transaction is likely to be taxed as a loan (reflecting the underlying economics). Only the implied financing cost will generally be deductible – and this will be subject to the new corporate interest restriction rules which can cap tax relief for interest at 30% of EBITDA. The corollary of that is (assuming a number of bear traps are avoided) the sale is not taxed as a chargeable gains disposal such that the upfront capital sum is not taxed.

Stamp duty land tax will arise for the investor on the sale. But, if structured appropriately, relief ought to be available for the company on the leaseback.

A company that does not recover all its VAT would want to ensure that the investor did not "opt to tax" the real estate so that the rent is not increased by VAT (which would be an absolute cost). That may mean the investor cannot recover VAT on its deal costs – but that should be the lesser of the two costs and, as a known item, could be taken into account in pricing. Companies that have received certain zero-rated supplies will want to check there could be no deemed VAT reverse charge – if there is, it may be possible to restructure.

There are likely to be a number of other points to bear in mind on a real estate deal (e.g. the normal anti-avoidance rules and the non-resident landlord scheme) – but those are unlikely to impact pricing materially.

Conclusion

Ground rent transactions provide real estate owners with upfront capital sums for affordable payments. Investors are keen on them because of the long-term (sometimes index-linked) income stream and the quality security package. So, for the right assets, there is a good alternative to normal debt finance.

FOR MORE INFORMATION

Should you like to discuss any of the matters raised in this Briefing, please speak with a member of our team below or your regular contact at Watson Farley & Williams.



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