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Ground Leases and Leasehold Interests in CMBS: When the Value of the Parts Doesn't Equal the Whole

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The Chrysler Building has been an iconic presence in the New York skyline since the 1930s when its distinctive Art Deco dome and spire rose up into the sky. But the story of this Midtown office tower ownership highlights certain important risks regarding the economics of the ground lease contract between ground lessor and ground lessee. It also raises the question of what happens if, for any number of reasons, a property's leasehold improvements cannot bear the burden of ground lease rent payments that only increase over the typically very long period stipulated in such agreements.

The Chrysler Building was constructed on land owned by the Cooper Union school, which entered into a long-term ground lease with the developer and as ground lessor, has enjoyed a steadily increasing income stream of ground-lease payments ever since. By 1998, however, occupancy had stagnated under previous ownership. The once majestic office tower was in need of repair and the Japanese lenders wanted to sell the defaulted leasehold mortgage they had made on the famous property. Tishman Speyer (Tishman) and Travelers were the winning bidders, in part because Jerry Speyer himself reportedly negotiated a more economical 150-year ground lease with Cooper Union beforehand and took over the leasehold interest. The new owners believed that after $100 million in capital improvements, leasing would improve and tenant lease revenue would easily cover the future ground-lease payments.

Under Tishman Speyer's leadership, the repairs were made and the Chrysler Building once again leased up and increased in value along the way. The investment seemed to be a great success, and it was for a while. However, the ground-lease agreement contained a rent clause prevalent in New York City that allows for a market-based reset over a longer period to account for possible appreciation catch-ups. There was a big problem, though. The older floorplates and infrastructure of the building were becoming less desirable to tenants. The increasing ground rent payment began to overwhelm the property's revenue as the aging building's occupancy and rental rates continued to lag much newer properties.

In 2008, Tishman sold a 90% interest in the building to the Abu Dhabi Investment Council for $800 million, or $667 per square foot (psf). Then in 2018, the market-value-based ground rent reset provision triggered a more than 300% increase in the annual lease payment, as it shot up to $32.5 million from $7.5 million the prior year at a time when the property's rental income was dropping. Per Reis, the Chrysler Building's 2019 average asking rent and vacancy were $66.31 psf and 18.5%, respectively, compared with the 2019 New York Metro average asking rent and vacancy of $75.26 psf and 8.2%. When Tishman and Abu Dhabi sold the building in 2019 to RFR Realty LLC (RFR) for a mere $150 million, it stunned the commercial real estate world. The price equated to just $125 psf, indicating that the leasehold and the existing improvements were of very little value, even for an iconic landmark. Now the question remains: Will RFR be able to negotiate a new ground-lease agreement like Jerry Speyer did in 1998? If not, the investment in the leasehold interest could be destined for failure once again.

Bifurcating the Fee and Leasehold Interests

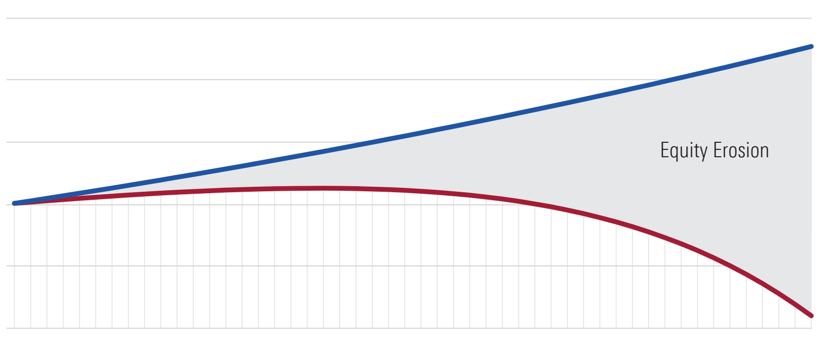
Ground lease arrangements have existed for centuries in real estate. The typical ground lease results in two distinct legal estates: the ground lessor's fee interest in the underlying land and the ground lessee's leasehold interest in the improvements. These two estates, subject to the terms of the ground lease, can then be separately owned and financed. In the normal course, the ground lessor enjoys a highly predictable and generally well-secured payment stream sometimes for as long as 100 or more years. The ground lessee owns a leasehold and is left to focus on operating the real estate improvements, while often benefiting from favorable tax and depreciation treatment. For the most part, ground-lease payments were a modest portion of the leasehold owner's operating expense burden and a safe, reliable income stream for the landowner. Up until recently, it was difficult to find examples of a ground lessee defaulting on a payment to the lessor. After all, the consequences are extreme. If the ground lessee defaults, ground lessors can terminate the ground lease, extinguish the ground lease estate, evict the ground lessee, and take back the property improvements. If the leasehold interest is financed, the leasehold lender has similar risks in a default situation. If the leasehold interest is terminated, the leasehold lender risks losing its collateral entirely. Of course, leasehold loans and associated ground leases (to be financeable) are generally structured to give the leasehold lender remedies in this situation, including rights to cure any defaults and effectively step into the shoes of the leasehold borrower.

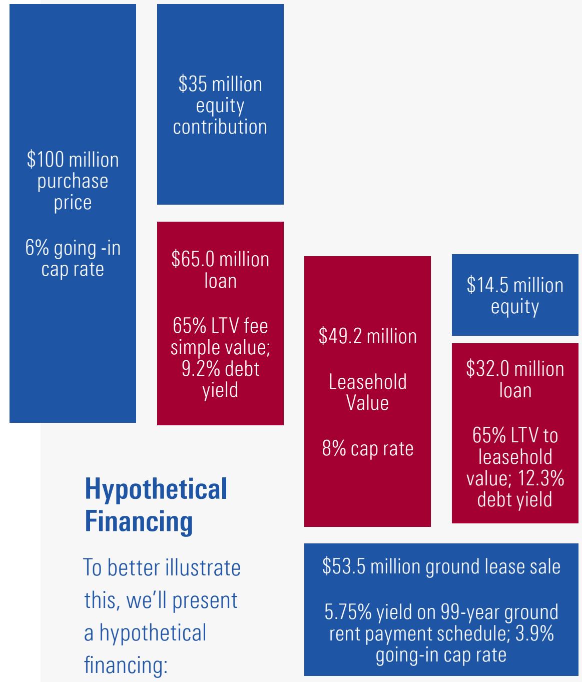
So what has changed? Land value in New York City, for example, continued its steep rise. Property owners and financing agents saw more opportunities to unlock that increased value by bifurcating the fee and leasehold interests and financing both interests. Real estate investors seeking acquisitions sought to split off and sell the ground fee interest to lower their equity contribution and increase their cash-on-cash returns retaining the leasehold and financing it as well.

But there is a catch, of course. The ground-lease agreement is long, the ground rent payment keeps going up, and property revenue also needs to keep pace with this increase. Thus, the transaction parties must be confident that tenant rents will also grow over time and that the property will remain attractive to future tenants. Otherwise, the ground rent burden on the leasehold interest begins to creep up. Moreover, the leasehold interest, the term of which is finite, is viewed as a wasting asset that becomes worthless when occupancy rights revert to the leased fee holder at the termination of the ground lease. As shown in the graph below, there is significant equity erosion in the leasehold interest compared with a fee-simple interest over an assumed 50-year ground lease term. In this example, we assumed a 2% annual growth rate in NCF to match the 2% annual ground-lease rent increase. The leasehold interest value begins to deteriorate with 20 years remaining on the lease. With only 10 years remaining, the value begins to decline much more rapidly. As a result, if a leasehold loan on a property subject to a ground lease needs to be refinanced with only 20 years remaining on the ground lease, the expected valuation decline can make this exceptionally difficult.

EXHIBIT 1

Equity Erosion





Hypothetical Financing

To better illustrate this, we'll present a hypothetical financing:

A real estate investor spots an opportunity to purchase an office campus in a second-tier market. Based on the property's current net cash flow (NCF) and assumed capitalization rate of 6%, the investor will pay $100 million to purchase the property. And, based on prevailing lending conditions, we assume the purchaser qualifies for a mortgage loan at 65% of the purchase price, leaving $35 million to be funded through cash equity. However, the investor believes it can split off the ground fee interest and sell it to a third party subject to a long-term ground-lease agreement where the property is leased back to the original investor. This enables the original investor to continue to operate the property but also gain an immediate return from the sale to the third-party investor, which can defray its equity requirements. Depending on the economics and property quality, the leasehold financing can be a superior alternative. In this example, assuming a 99-year ground-lease term and beginning ground-lease payment of around 20% of the property's effective gross income (EGI), the purchaser is able to sell the ground-lease interest for $53.5 million at a 5.75% yield to the buyer (i.e., the discount rate applied to the 99 years of ground-lease payment cash flow to arrive at the net present value purchase price). That leaves the original investor needing only to obtain the leasehold financing. Even at a greatly reduced loan amount on the leasehold interest, the purchaser is contributing significantly less cash equity to buy the property while enjoying much higher returns over an assumed 10-year holding period. In this example, we assume a $32 million loan on the leasehold interest. When combined with the ground-lease sale, the borrower ends up contributing less than half the equity of a fee-simple financing.

Cracks in Ground Lease Financing in CMBS

The commercial mortgage-backed securities (CMBS) market has seen an increase in loans secured either by ground lessees' leaseholds or ground lessors' leased fees, and lenders have developed certain protocols or structures to protect themselves and mitigate some of the additional risks. More particularly, CMBS lenders have developed an industry standard list of requirements for a financeable ground leasehold that has evolved over time to address potential pitfalls that could result in various scenarios, including notice and cure rights for the lender. However, even if carefully negotiated up front, the economics of the ground lease for each party as effected by the loan documents can result in a disconnect and unintended consequences when circumstances change.

We have noticed a growing number of examples in the CMBS market where cracks are showing on both the leased fee and leasehold side. The primary credit risk in a CMBS ground-leased fee loan usually lies in the borrower's ability to refinance in a rising-interest-rate environment, thus having to come out of pocket to make up for the possibility of a new lower mortgage.

EXHIBIT 2

Noteworthy Leasehold Loans

Deal Name	Loan Name	Leasehold/ Leased Fee	Property Type	Loan Balance ($)	Loan Status	Specially Serviced
SFAVE 2015-5AVE	Saks Fifth Avenue	Leased Fee	Retail	1,250,000,000	Current	No
MSBAM 2013-C9, MSBAM 2013-C10	The Row NYC Hotel	Leased Fee	Lodging	275,000,000	Delinquent	Yes
HMH 2017-SSC	Hospitality Portfolio Rollup	Leasehold	Lodging	204,000,000	Delinquent	Yes
GSMS 2019-GC42	2 Cooper	Leasehold	Multifamily	65,000,000	Delinquent	No
COMM 2012-LC4	Johnstown Galleria	Leased Fee	Retail	13,551,525	Delinquent	Yes
COMM 2014-UBS5	Campus at Greenhill	Leasehold	Office	23,073,174	REO	Yes
COMM 2015-DC1	Campus at Greenhill	Leased Fee	Office	21,660,000	Current	No
JPMBB 2014-C18	545 Madison Avenue	Leasehold	Office/Retail	-	Liquidated	-

Historically, it has been very uncommon for CMBS ground-leased fee loans to encounter stress caused by prolonged nonpayment of rent from the ground lessee. But now we are observing instances where the economics of the related ground-lease agreement impair the value of the leasehold interest and vice versa. In fact, it's possible in some cases that the ground lease doesn't survive the loan resolution. That is, in certain instances, the ground lease has been terminated and the leasehold lender has been left with no collateral and no effective remedies. The CMBS market seems to have caught on to this, and leasehold loans have appeared less frequently in conduit pools over the past several years. Leased fee loans secured by the fee (ground underneath) commercial properties are still common in CMBS, but we believe they deserve closer scrutiny. Some of the examples that follow will serve to better explain why.

Saks Fifth Avenue

Retail | Leased Fee | $1,250,000,000

In 2015, Hudson's Bay Company (HBC) took advantage of a healthy New York real estate market to unlock the value in its Manhattan flagship Saks Fifth Avenue (Saks) store. It did this by executing a sale leaseback transaction totaling $1.25 billion securitized in SFAVE 2015-5AVE (rated by DBRS Morningstar) and used the proceeds to pay down a $1.20 billion bank term loan. The ground-lease agreement requires annual increases at the higher of 3.25% and the Consumer Price Index (CPI), with market resets in years 36 and 66 allowed at 6% of land fair market value as if vacant, unimproved, and unencumbered. Fast forward just five years to a much different world today where even pre-Coronavirus Disease (COVID-19), HBC and Saks were struggling to adapt to a secular shift toward online shopping that has lessened demand for physical locations. Fifth Avenue in Manhattan had traditionally been considered a must-have location for many of the world's popular retailers, which paid rent as high as $3,000 psf to have a presence along the prestigious shopping corridor. But the pandemic has accelerated growth in online shopping demand, weakening even the best brick-and-mortar locations. This, in turn, has called into question the current value of the venerable Saks Fifth Avenue building.

We tackled this important question last October when we placed the bonds backed by the ground leased fee Under Review with Negative Implications. In our look-through NCF analysis and fee-simple value assessment, we determined our view of the property's stabilized value by evaluating the building as if it were converted to its highest and best use as a mixed-use office and retail property. Our analysis produced a NCF 30% lower than in-place, and a $1.4 billion DBRS Morningstar value based on a 6.5% capitalization rate. That's 63.6% less than the original 2015 $3.7 billion fee-simple appraised value, but still a very respectable $2,325 psf. This gave us some assurance that enough value remains in the building to cover the loan amount if Saks flounders. The loan remains current on its debt service payments, but DBRS Morningstar remains concerned about Saks' ability to keep its doors open.

HMH 2017-SSC

Lodging | Leasehold | $204,000,000

Loans backed by lodging properties are more exposed to performance volatility through economic cycles, and the pandemic has been especially hard on CMBS. Hotel leasehold mortgages can be even more vulnerable if the ground-lease payment is an outsized portion of the borrower's fixed expenses that have to be paid regardless of whether the hotel is open. In 2017, the Shidler Group securitized a $204 million mortgage loan secured by 22 limited-service, select-service, and extended-stay hotels spread across 10 MSAs, with more than half located in California, Florida, and North Carolina.

The borrower's indirect equity interest was also encumbered by a $25 million mezzanine loan. All but one of the 22 properties are leasehold interests. At issuance, the ground-lease payments accounted for 9.5% of the trailing 12-month (T-12) revenue and 13.2% of T-12 total operating expenses.

The portfolio's 2019 NCF was 3.4% lower than the issuance underwritten amount and 14.0% lower than the increasing 2018 NCF. Then the pandemic hit and the loan was transferred to special servicing in June 2020 for a coronavirus-relief request, as the properties were reportedly averaging just 10%–15% occupancy at the time. The borrower immediately expressed an interest in transferring its equity interest to the mezzanine lender. The special servicer noted that discussions with the mezzanine lender have stalled. The loan matures in June 2022, and the depth of the crisis has led to speculation that it will take several years for hotels to climb back to a RevPAR level anywhere near the 2019 peak in lodging. In the meantime, there are $11.7 million of outstanding P&I advances and ASERs as of January 2021. The ground-lease payments remain current because, after its transfer to the special servicer, a receiver was appointed and is remitting them from property cash flow. The $173.2 million revised appraised value reported by the special servicer in November 2020 is down 51.4% from $356.6 million at issuance. If the mezzanine lender decides not to step in and make the mortgage payments, the trust may have little choice but to foreclose and sell the hotels at what would likely be a complete loss to the junior certificateholders.

The Row NYC Hotel

Lodging Leased Fee $275,000,000

The pandemic has hit New York City CMBS hotel assets so severely that even some ground-leased fee loans are in jeopardy. The once dilapidated 1,331-room Milford Plaza hotel in Midtown Manhattan was purchased in 2010 for $200 million, and the new ownership divided the improvements into separate hotel and retail condominium units. After spending more than $150 million to renovate the hotel and rename it The Row NYC, the owners sold the underlying fee interest in 2013 for $350 million to a joint venture between the Los Angeles County Employees Retirement Association (LACERA) and New York real estate investor David Werner.

David Werner financed the ground-leased fee acquisition with a $275 million ($206,612 per room) CMBS loan split between MSBAM 2013-C9 (rated by DBRS Morningstar) and MSBAM 2013-C10 (not rated by DBRS Morningstar). The 99-year ground-lease agreement had an initial payment of $16.25 million with an annual increase tied to CPI, or 20% of the DBRS Morningstar's 2013 look-through hotel gross revenue assumption. The appraiser concluded $386 million for the fee-simple land value ($290,008 per room) resulting in a 71% loan-to-value ratio (LTV) for the 10-year interest-only loan at a 3.48% rate and 1.67x debt service coverage ratio (DSCR). Even before the coronavirus shutdown, the hotel was falling short of expectations set at issuance. During our 2017 surveillance review, we received an STR, Inc. report indicating the hotel's T-12 through June revenue per available room (RevPAR) was $175.43. This was well short of the borrower's 2013 budgeted RevPAR of $192.63 but still higher than the DBRS Morningstar assumption of $163.71. With rising operating expenses and a high debt payment, the leasehold loan defaulted in 2018. In early 2019, it was reported that the leasehold interest was being shopped at an asking price of about $200 million but didn't see any bids.

With neither the ground lessee (leasehold borrower) making ground rent payments nor the leasehold lender stepping in to cure the ground rent payment default, David Werner stopped making debt service payments on the CMBS ground-leased fee loan, which transferred to special servicing in May 2020 and is 120-plus days delinquent. It's likely that the CMBS trusts will foreclose on the hotel fee interest and seek to recover enough from a liquidation to pay off the fee interest loan. While we don't expect bondholders to take a loss, the fate of the asset's disposition relies on New York City lodging rebounding from the ongoing pandemic-induced shutdown. On a separate note, before handing the keys back on the Milford/Row hotel, nonrecourse debt financing on the leasehold interest seems to have worked out quite well for the leasehold borrowers. After spending $350 million to acquire and renovate the fee-simple interest in the property, the venture then sold the land and retail condo interest for a combined $415 million and borrowed $255 million of nonrecourse financing on the leasehold improvements.

2 Cooper

Multifamily Leasehold $65,000,000

The multifamily sector has remained resilient through the pandemic with the exception of such gateway cities as San Francisco and New York, whose populations have experienced a well-publicized exodus to more rural areas to weather the virulent storm. In Manhattan, the impact has crept its way into CMBS. In December 2020, a $65 million loan secured by the leasehold interest in the 2 Cooper apartment building was reported as 30 days delinquent. It's the third-largest loan in the GSMS 2019-GC42 transaction (rated by DBRS Morningstar). In 2019, property investors David Werner and Isaac Kassirer used the proceeds along with preferred equity supplied by a ground lessor affiliate to acquire the property at a $699,301 per unit purchase price. Kassirer is CEO of Emerald Equity Group, and as the loan's recourse carve-out guarantor, he was assigned a sponsor ranking of Average by DBRS Morningstar because of his slim $4.2 million reported liquidity.

At issuance, the loan faced a Section 421a tax abatement expiration in 2022 coupled with a contractual 20% ground rent increase in 2025, both of which were accounted for in DBRS Morningstar's 23.7% haircut to the issuer's NCF. 2 Cooper's actual ground-lease burden at issuance was only around 14% of EGI, though 15% of that rental income is paid by ground-floor tenant Crunch Fitness. While the gym is currently open, the potential loss of this retail rental income, combined with a prolonged drop in apartment rental rates and occupancy, could put the loan into default if the borrowers are unwilling or unable to support debt payments. In December 2020, it was reported that another lender is foreclosing on a $203 million loan secured by Emerald Equity's Harlem apartment buildings after the borrower entity filed for Chapter 11 bankruptcy. The good news is that at a 56.7% LTV, 2 Cooper's leasehold value would need to drop substantially to put the trust at risk of a loss.

Johnstown Galleria

Retail | Leased Fee | $13,551,525

A theme playing out over the past 10 years has been the decline of the American mall. Though most CMBS loans made to mall owners are primarily to the fee-simple interest in both the land and improvements, a few are on just the fee interest in the land. The $13.5 million Johnstown Galleria leased fee loan securitized in COMM 2012-LC4 (not rated by DBRS Morningstar) is one such asset where the borrower's ownership interest is only in the land beneath a mall. In 2018, both the Bon-Ton and Sears stores closed at the Johnstown, Pennsylvania, regional mall. Only two of the four anchor boxes are occupied with JCPenney and Boscov's remaining open. According to recent reports, though the mall's in-line space was 92% occupied prior to coronavirus-related shutdowns, rent collections at the mall dropped to 32% in June 2020 from 70% in April. Occupancy was reported at 75.5% as of July 2020. The borrower defaulted on its loan, which is more than 90 days delinquent, after the leasehold owner stopped making ground rent payments, prompting the loan's October 2019 transfer to the special servicer. The borrower is pursuing remedies against the ground lessee to terminate the lease and evict it as the tenant in order to gain control of the improvements.

Based on an updated April 2020 appraisal, the ground value has plunged to just $11.3 million, 46% less than the at-issuance appraised value. This example demonstrates the full array of issues that can manifest when the improvements supporting a ground lease deteriorate in performance and value, essentially unwinding the entire transaction. In this case, the CMBS trust became the ground lessor and might be able to recover the full loan amount if it can also recover the leasehold improvements and sell the mall. The owner of the leasehold improvements, however, faces a complete loss, as does its lender. Though the leasehold mortgage is currently not a CMBS asset, it highlights the risk CMBS leasehold loans can face. If the leasehold borrower defaults on payments (or other obligations) under the ground lease, and the leasehold lender is not in a position to cure that default, the only other possibility is for the leasehold lender to try to renegotiate the ground-lease agreement with the ground lessor and decrease the payments. This rarely happens and is less likely if the ground lessor's fee is likewise encumbered. Instead, in the case of the Johnstown Galleria example, the ground lease is terminated, and the ground lessor is left to salvage the value of the improvements it takes back from the ground lessee.

Campus at Greenhill

Office	Leasehold	$23,073,174
Office	Leased Fee	$21,660,000

The Campus at Greenhill office building in Wallingford Connecticut is an example of a property where both the fee and leasehold interest were bifurcated, and both interests are financed and securitized in two separate CMBS transactions. The $23.2 million leasehold mortgage was securitized in COMM 2014-UBS5 (rated by DBRS Morningstar), and the $21.7 million leased fee interest is securitized in COMM 2015-DC1 (not rated by DBRS Morningstar). The 287,967-sf medical office property was completed in 2012 and leased primarily to Anthem Health as its national headquarters. The owner, Gale International, had purchased the unfinished property out of foreclosure in 2011 for $43.5 million ($151 psf) and poured another $28.5 million into completing and leasing it. In 2014, the fee-simple interest was appraised at $54.4 million ($189 psf). Gale International then sold the underlying land to a third party for $26.4 million subject to a new 98-year ground-lease agreement with a year one payment of $1.25 million increasing 3% annually, or 22.8% of the year one underwritten EGI. Gale International subsequently financed the remaining leasehold interest by obtaining a $26 million ($90 psf) 10-year mortgage with a 30-year amortization schedule, based on a leasehold appraised value of $35.2 million ($122 psf). The leasehold lender also provided a $3.2 million mezzanine loan. In total, Gale International pocketed $55.2 million, or $800,000 million more than the fee-simple appraised value.

Beginning in 2017, things began to go sideways for the leasehold mortgage. Anthem exercised its early termination option and paid a $1.3 million penalty, which the borrower failed to deposit into the cash management account as required by the loan agreement. The loss of Anthem's rent income, combined with a gradual phase out of a tax abatement, ever increasing ground rent payments, and mezzanine debt burden, began to put pressure on the property's ability to cover debt service payments. Eventually, the special servicer foreclosed on the asset, which then became real estate owned (REO) by the trust. A November 2020 appraisal valued the leasehold at just $13.1 million ($45 psf) – a 62% decline from issuance. Meanwhile, the ground-lease fee interest securitized in COMM 2015-DC1 was watchlisted because the borrower failed to meet the stipulated ground-lease coverage ratio in the loan documents. This triggered an excess cash flow sweep that remains in place today. For now, the ground lessor will likely assume that any prospective buyer of the leasehold interest will continue to honor the ground rent agreement and make the payments. The property continues to lag in occupancy, which was 75.0% at year-end 2019, down from 89.1% at issuance, and net cash flow continues to underperform, down nearly 75% over the same period. A prolonged slump in performance could mean The Campus at Greenhill will follow in Johnstown Galleria's footsteps. On the other hand, the office campus could benefit from the coronavirus-driven exodus of companies and their employees out of New York City. Currently, Reis is projecting that the property's New Haven market will experience around a 20% average vacancy rate over the next five years.

545 Madison Avenue

Office/Retail | Leasehold | $ –

Another cautionary tale in ground-lease sizing is 545 Madison Avenue. In November 2020, a CMBS loan secured by the leasehold interest in the New York mixed-use office/retail property liquidated at a near total loss to the trust. The $30.0 million loan on 545 Madison Avenue was securitized in JPMBB 2014-C18 and used to acquire the leasehold interest on this Class A property well-located at the corner of 55th Street and Madison Avenue in the Plaza District submarket of Midtown Manhattan. The 75-year unsubordinated ground-lease agreement was put in place in 2006 with 10% increases every five years. At origination, the $6.05 million ground-lease payment already amounted to 47.5% of the issuer's EGI (with an escalation imminently pending). At the time, the property was also benefiting from a tax abatement that would gradually phase out by 2020.

The acquisition strategy was to increase the in-place rents to market rates for both the retail and office tenants, because the previous owner had offered discounted rents to lease-up the property post-renovation. But by 2018, it seemed the plan was moving in the wrong direction, as occupancy had dipped to 85% from 93.3% at issuance. Yet, even with the loss of just a few tenants, the loan's DSCR dropped below 1.0x because of the higher ground rent and real estate tax expenses. The borrower, Thor Equities (Thor), stopped making ground rent payments, and. by mid-2019, the loan was transferred to special servicing because Thor also stopped making loan payments. The ground lessor obtained a warrant of eviction, but the special servicer had contractual cure rights and filed a cause of action asserting its right of redemption. An updated appraisal valued the leasehold at literally zero. The special servicer opted not to pursue any remedies and the trust took about a 97% loss. The ground fee owner, Joseph E. Marx Company, owns the land unencumbered and now also enjoys the benefit of owning the renovated improvements free and clear.

Warning: Rising Ground Lease Payments

Typically, when analyzing leasehold interests, we flag any ground-lease payment that begins to exceed about 20% of the property's EGI because, over time, the rising payment obligation could put the property in a hole it can't climb out of. Both the Campus at Greenhill and 545 Madison are prime examples of this. We flag any market-based resets, particularly if not easily quantifiable. A leasehold owner may face several lease expirations and may need to spend significant capital in order to keep the existing tenants or attract new ones. At the same time, rental income could drop, but significant operating expenses such as real estate tax and ground rent must also be paid. The leasehold owner might be faced with decreasing cash flow available to re-tenant, or even simply maintain, the property. The ground lessee could also quickly be faced with covering debt service payments on its leasehold loan out of pocket as well, leading to a cascading capital deficit. Ultimately, if the value of the improvements looks to be impaired for an extended period, the leasehold property owner may choose to walk away from the investment if the ground lease cannot be restructured. Though the ground lessor will be able to reclaim the improvements, it too may often be left with an impaired asset that requires significant capital to remain viable.

The foundation of our ground-leased fee analysis lies in the assumption of a viable long-term view of a property's fee-simple stabilized value over 10 or more years. We apply the *DBRS Morningstar North American Commercial Real Estate Property Analysis Criteria* to determine property rent income and expenses. We then apply our *North American Single-Asset/Single-Borrower Ratings Methodology* to establish an appropriate capitalization rate to the concluded property cash flow and apply the resulting value to LTV sizing benchmarks associated with each rating category. Depending on the property type, we may employ an additional layer of analysis to validate the rating conclusion. For example, we might use an alternative property dark-value assessment as a check against the appropriate LTV benchmark rating category. There might also be cases where we consider the probability of a real estate asset becoming permanently impaired from gradual obsolescence. An older property, such as the Chrysler Building, may simply become too expensive to maintain and operate, or a retail center may eventually yield to changing demographics and shopping trends that alter its highest and best use to something completely different such as office or industrial space.

Striking a Balance

Ultimately, if a property is subject to a ground lease, a balance must be struck between the economics of owning and financing the fee and leasehold interests. The ground lessor is attracted to the stable income stream a well-positioned property can support over a long period of time, while the ground lessee can focus on maximizing the value of its improvements and also possibly enjoy certain tax benefits. An ownership bifurcation can also optimize a property owner's desired return on investment by creating a ground lease and selling the ground interest to a long-term investor. As long as the parts equal the whole and the debt leverage applied to each interest properly considers the risks, each party can benefit from such an arrangement. While the examples highlighted here may serve to warn about a misalignment of those interests, they also can help elucidate this to the market in order to help avoid future pitfalls when evaluating ground-lease economics in CMBS.

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