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## **Valuation of leasehold improvements in a ground lease - by Frederick Richard**

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The valuation of a leasehold estate in a ground lease provides several challenges for the real estate appraiser. The leasehold interest in a ground lease is created through the tenant's lease of an underlying site for a specified period of time. Upon leasing the site, the tenant will typically construct leasehold improvements for either their own use, or a future tenant's use. Upon expiration or termination of the ground lease, the tenant's right to occupy the property will cease and any leasehold improvements will revert to the underlying land owner.

The leasehold interest in a ground lease is most often valued through use of the income capitalization approach. Within the income capitalization approach, income to the leasehold estate is measured as the difference between the net operating income to the leasehold improvements less the underlying ground lease payment. Direct capitalization and discounted cash analysis may both be used in order to capitalize net operating income into an indication of value. The approach selection is largely dependent upon the term remaining on the ground lease. If the ground lease recently commenced and extends for a long period of time, direct capitalization may be the sole method used by the appraiser to value the leasehold improvements. However, since the leasehold interest does not include any reversionary benefits to the tenant, discounted cash flow analysis may be the most relevant and applicable approach, particularly with regards to a lease with a short remaining term.

Whether direct capitalization or discounted cash flow analysis are chosen, care must be exercised in the selection of an appropriate rate of return. Market extraction is the preferred method to use in order to estimate a reasonable overall capitalization rate for use in direct capitalization. If there is a lack of comparable leasehold improvement sales, transactions of comparable properties whereby investors are acquiring the leased fee interest in both the site and building may be used. However, an adjustment is necessary to the rates extracted from these sales. Typically, the return requirements for leasehold improvements are higher than the requirements for leased fee interests in both the site and building. Factors influencing the premium include marketability and financing concerns, as well as the lack of any reversionary benefits.

During the course of an appraisal assignment of a leasehold estate in a mixed-use property, several market participants were surveyed to justify the extent of such a premium. The market participants included investors, brokers and lenders. The respondents indicated spreads above leased fee rates ranging between 50 and 200 basis points, with one respondent indicating minimal impact on the going-in capitalization rate, depending on the quality of the asset. One respondent indicated that the length of the remaining term can have a significant impact on a property's ability to attract debt financing, with one lender requiring a minimum of 50 years remaining on the ground lease term, to include option periods. Another respondent pointed to a limited pool of buyers that would be attracted to such an asset thus limiting its marketability. Ultimately, the premium chosen by the appraiser, if any, should consider the remaining term of the underlying ground lease, the economics of the lease and the quality of the leasehold improvements.

With a short term remaining on the ground lease, discounted cash flow analysis represents the best method of valuation, as this approach can explicitly consider the lack of any reversionary benefits to the ground tenant. Similar to the selection of an appropriate capitalization rate, the discount rate used in the analysis must reflect the yield requirements for a leasehold estate and consider the potential marketing and financing risk faced by an investor.

Although the income capitalization approach is ideally suited for the valuation of leasehold improvements, both the sales comparison and cost approaches may also be developed. In both instances, the fee simple or leased fee interest in the site and building improvements is estimated depending upon the ownership structure of the leasehold improvements. From the initial value indication, the value of the ground lessor's interest in the underlying ground lease is deducted. The residual represents the leasehold market value of the property.

In valuing the leasehold interest in a ground lease, the terms and economics of the agreement must be fully analyzed by the appraiser. Of particular importance is the term remaining on the lease, and its potential impact on the appeal of the property to investors. A thorough understanding of the terms of the ground lease and how they relate to investor requirements will guide the appraiser to the most relevant methods of valuation.

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