Leasehold property: attractive investment opportunities with diverse risk drivers

Leaseholds open opportunities for several types of investors with different risk appetite, i.e. either investing into the property build on the "leased" land or investing into the land and leasing the right to build a property. The latter faces lowest risk profile due to stable cash flows supported by strong security package granted by the legislative framework and contractual rights. It also eliminates risks which are otherwise relevant to standard commercial real estate investments such as maintenance and management of tenants.

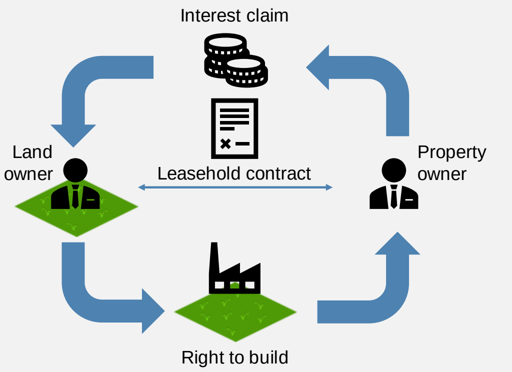
German leasehold rights celebrated their centenary in 2019. As a result, a growing number of leasehold maturities have materialised. The media, referring to "leasehold hustle", reported on a case where the city of Hamburg increased the real charge due on the leasehold when the lease expired. As the value of the land forms the basis of the charge, an adjustment at extension is only natural.

The German leasehold law became effective on 15 January 1919, originally to deal with scarce living space in rural areas, as a result of returnees and refugees during and after the First World War. The intention was that heritable building rights would enable people with little income to own their own homes and prevent land speculation.

Figure 1: Hereditary building rights - summary

Under a leasehold, which splits ownership of the land and the property built on it, the landowner, as a so-called lender of heritable building rights, grants the tenant, the property owner, the right to use the land under the building lease.

The tenant pays a ground rent for the duration of the lease. As the sole owner of the building, the tenant is entitled to any income from the property built on the land.



The most common use of leasehold is to build residential property. The advantage for the builder is that the purchase of the land is not required, which reduces the purchase price and benefits financing. Leaseholds are usually contracted for 60 to 99 years. However, these rights can be extended as often as required after expiry.

Leaseholds can also be applied to commercial real estate, where various economic benefits from splitting ownership of the land and the property foster its use. For example, the property owner, renting out the property built on the plot under the leasehold can deduct the leasehold payments from his taxable income. On the other hand, tax-relevant write-downs on the land itself are not possible.

Also, a company can create liquid assets if it legally splits the self-owned land and property and sells the land accordingly. This releases equity for investments while the interest due remains tax-deductible. Further, a property seller can earn a premium if a commercial property was sold separately from the land it is built on, as the seller can serve different investor types: risk-averse fixed-income investors investing as lenders of heritable rights, and investors with stronger risk appetite investing in managing the rented property.

This report focuses on German commercial leasehold while in parts it is applicable also to other legislation.

Analysts

Mathias Pleissner
+49 69 66 77 389-39
m.pleissner@scoperatings.com

Sebastian Dietzsch
+49 30 27891-252
s.dietzsch@scoperatings.com

Media

Keith Mullin
k.mullin@scopegroup.com

Related Research

Healthcare: an attractive segment for alternative real estate investment - Dec 2019

Berlin rent freeze: bigger property companies may benefit from market intervention more than tenants - Oct 2019

Unpredictable Brexit outcome increases UK CRE credit risk - April 2019

German CRE rents: five observations - Feb 2019

Scope Ratings GmbH

Neue Mainzer Straße 66-68
D-60311 Frankfurt am Main

Phone +49 69 66 77 389 0

Headquarters

Lennéstraße 5
10785 Berlin

Phone +49 30 27891 0
Fax +49 30 27891 100

info@scoperatings.com
www.scoperatings.com

Bloomberg: SCOP

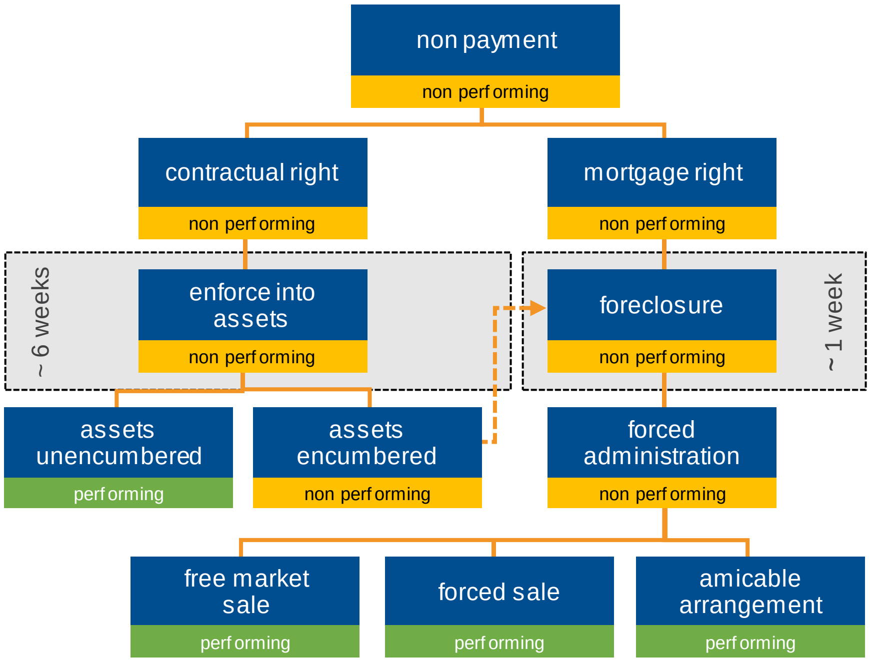
Contractual and real recourse options supportive

Double recourse under contractual and mortgage claim

The leasehold's credit profile benefits from double recourse and high seniority. The interest claims of an investor in the leasehold are supported through i) a contractual right under the leasehold agreement and ii) a heritable building right ("the claim in rem") which is registered in the mortgage register.

In both cases, an enforceable title facilitates enforcement.

Figure 2: Exemplary legal options



Source: Scope Ratings

Most promising – foreclosure into the claim in rem

The mortgage right is typically registered as first-lien, from which enforcement can be demanded and which in general is only subordinated to already existing easements such as limited non-financial rights or use rights. Filing for foreclosure under the mortgage allows execution within a very short timeframe. Historically it has taken a week until sequestration and the forced administrator is appointed. At that point, any income under the property follows a strict regulatory waterfall, which in most cases ensures that interest on the leasehold is paid even during foreclosure proceedings.

Strong benefits from legal senior position

The mortgage right ranks senior to any other non-mortgage claims but junior to costs of the enforcement procedures (e.g. court fees), administration costs[1] and public charges. Also, required capital expenditures in order to preserve income generation of property (e.g. operating expenses and maintenance costs) rank senior.

Enforcing into the assets of the property owner less effective

The contractual right is comparably less effective as it will likely take longer to enforce and is not as promising should the rental accounts be pledged to a financing bank (assets encumbered). This may reflect negatively on the timely payment of leasehold interest. Enforcing into the assets of the property owner allows the land owner to attach into the rental or general accounts of the property owner. However, this may take six weeks on average and can only be successful if the relevant accounts are not already pledged to a potential financing bank.

[1] Administration costs will likely not exceed the legal guidance of approximately 10% (regular salary), administration costs do not cover for non-recoverable costs.

Security of last resort – "Heimfall"

A legal specification of the German leasehold is the "Heimfall" under which the land-owner can purchase the property (generally at a discount of the-then valid market value) in case leasehold payments remain overdue for two years or if foreclosure proceedings are initiated against the property owner. We see the "Heimfall" as rather theoretical, as the insolvency administrator can litigate if other creditors were discriminated against. Even so, the "Heimfall" highlights further the strength of the legal support available to leasehold.

Timely payments even under enforcement procedures

Special administrator takes over with the mandate to ensure timely payments on the mortgage rights

Payments are likely to continue without payment disruptions even under forced administration, regardless of its outcome: an amicable solution, a free market sale, or a forced sale.

In case of an enforcement into the mortgage, (from the day of sequestration), the special administrator will have exclusive, immediate and direct access to the respective property built on the land. The property cash flows, in particular the rental income from existing leases for the building, will be used primary to satisfy claims from any liabilities with registered mortgage rights in line with the legal waterfall[2].

No cash flows are transferred to the general account of the property owner until all creditors including the leasehold provider are fully satisfied. Any pledges and claims to any subordinated creditor of the tenant under the building lease will be suspended and considered subordinated to the claims due from the leasehold[3].

Forced sale starting from a clean slate again

Finalising enforcement may result into continuation of the leasehold

In the event that the property (together with the leasehold right) is sold, the acquiring entity is bound to fulfil all claims and duties of the leasehold agreement if it enters into the contractual leasehold agreement with all claims and duties. This, for example, includes inter alia, leasehold interest, subject to potential indexation and insurance as well as maintenance obligations. If the acquiring entity does not enter into the leasehold agreement with all claims and duties, it enters at least into several legal duties out of the claim in rem, e.g. into the duty to pay the leasehold claims. The owner of the land can refuse the buyer if this (veto right) is recorded into the land-register. Such veto right also exists with respect to an orderly sale, to protect the landowner partially against unwanted strategy changes, unskilled management or riskier owner structures in general.

Recovery proceeds – after deduction of amounts payable to senior creditors (senior costs) – will be used to satisfy any overdue leasehold interest from the day of sequestration until forced sale and up to two years prior to sequestration.

Analytical considerations for a German leasehold investment

Scope's analysis determines the expected loss associated with payments contractually promised (under the leasehold agreement and the mortgage right [claim in rem]), by an instrument (the leasehold or hereditary building right), on a payment date or by its legal maturity. It factors in both the likelihood of default on such payments and the loss severity expected upon default.

Exposure at default limited to interest payments. No principal exchanged

From a credit risk perspective, the leasehold benefits from limited exposure i.e. promised payments consist of the interest real charge to be paid by the property owner (the tenant under the building lease) only. There is no principal exchange or final payment at the maturity of the leasehold. The right to build on the land goes back to its owner, which effectively eliminates refinancing risk. In addition, claims in a recovery scenario

[2] Any overdue leasehold claims (interest until sequestration) will be suspended (but recoverable up to two years from sequestration) if a forced sale is conducted.

[3] If a subordinated creditor files for enforcement in form of a forced administration, this will not change any of the procedures and ranking described above.

accumulate to maximum annual interest charges, before the property is finally sold. The German leasehold legal framework generally guarantees a high protection of these claims through the property, given its preferential provision as a registered mortgage claim in the foreclosure waterfall. Compensations payments at maturity may be negotiated in the leasehold contract, while the most common case will be the extension of the leasehold agreement accordingly.

Remoteness of payment interruption is a prerequisite for a low risk profile

Despite the high expected recovery rates, low-risk-appetite investors generally also seek income stability, with only a remote possibility of a payment interruption. Our analysis of a leasehold's credit profile considers both, the strength and stability of the property cash-flow, as well as the structural mitigants, such as reserves or guarantee providers.

Long risk horizon partly relievable by strong leasehold agreement

Different to a "normal" commercial real estate obligation, the risk horizon of a German leasehold with 100 years or even more materially exceeds the three to seven years of risk horizon we generally see for commercial real estate transactions. The long risk horizon exposes the leasehold investor to regulatory or political changes that might impair the value of its investment. Further, the usage type and relative quality may be subject to changes during this long period. A leasehold contract may tie the property owner to maintenance and capital investments in order to maintain at least the current standards while structural risks exist which are highest for properties located outside high prime urban areas.

Location and condition of the property key

Due to the long risk horizon, our analysis reflects a stressed through-the-cycle performance of the property. In light of the long risk horizon we focus our analysis on the sustainability of the property's location and condition. We analyse the respective risk metrics: the property's capacity to generate rental income and the volatility of cash flows and compare this to the typical mix expected for this type of asset within the respective location.

We review what elements of the leasehold agreement ensure that the property will remain at least at its current condition, while any major change that might affect the property's use is subject to the landowner's approval. This includes renovation, refurbishment or even rebuilding measures and full insurance coverage. Additionally, we review all covenants that restrict the property's leverage and the set of additional veto rights granted to the landowner.

Going concern more likely than liquidation

We believe that a liquidation scenario is an unlikely event due to the superior treatment of the leasehold under a forced administration, which we see as the most reasonable solution should the tenant under the building lease fail to pay its interest charge.

Even if the outcome of the foreclosure is a forced sale, the new buyer of the property would have to step into at least the obligation to pay interest due from the mortgage right (the hereditary building interest real charge).

Strong enhancement results into low loss expectation

Should the stressed cash flows minus costs under the enforcement be insufficient to ensure timely payments a liquidation will be assumed, however. Still, the interest due is secured by the whole value of the property, likely allowing for very strong recoveries.

Scope Ratings GmbH

Headquarters Berlin

Lennéstraße 5
D-10785 Berlin

Phone +49 30 27891 0

Frankfurt am Main

Neue Mainzer Straße 66-68
D-60311 Frankfurt am Main

Phone +49 69 66 77 389 0

Paris

1 Cour du Havre
F-75008 Paris

Phone +33 1 8288 5557

London

Suite 301
2 Angel Square
London EC1V 1NY

Phone +44 203-457 0 4444

Madrid

Paseo de la Castellana 95
Edificio Torre Europa
E-28046 Madrid

Phone +34 914 186 973

Milan

Via Paleocapa 7
IT-20121 Milan

Phone +39 02 30315 814

Oslo

Haakon VII's gate 6
N-0161 Oslo

Phone +47 21 62 31 42

info@scoperatings.com
www.scoperatings.com

Disclaimer