SO WHY WOULD YOU BUY A LEASED-FEE INTEREST?

There are several reasons to purchase a leased-fee interest - lower acquisition cost compared to fee simple, consistent income throughout the term of the lease, appreciation potential, and lower maintenance cost and effort. As an investor, you definitely want to be on the leased-fee interest side of the lease!

The leased-fee interest acquisition cost is substantially lower than if purchasing the fee simple interest in the property.

As with many other types of investments, the value is determined by the income generated by the asset. The leased-fee owner receives monthly lease rent as determined by the terms of the lease. The lease rent at the start of the of the term is fixed for the first 5 years and then increases every 5 years at a minimum 3 1/2 per year or at the Consumer Price index whichever is larger.

In addition to the income, the other variable that drives the leased-fee interest acquisition cost higher is the appreciation in value of the land and home. At the end of the lease term , the land and any improvements revert back to the leased-fee owner, and it becomes fee simple ownership interest in the property.

Not only does the leased-fee owner receive income in the form of lease payments, but they also save on the expenses for the property. Ground leases shift the responsibility of all expenses, such as property tax, maintenance fees, etc. to the leasehold owner. In addition to the significant reduction in expenses, the leased-fee owner does not have to maintain the improvements or manage tenants in the case of a sublease.

WHAT HAPPENS AT THE END OF THE LEASE?

Almost all the leases dictate the property reverts back to the leased-fee owner at the end of the lease.The leased-fee owner can offer to extend an existing lease, renew the lease, or even offer to sell the leased-fee interest. If the leased-fee owner decides not to extend or renew the lease, or sell the leased-fee interest, the leasehold owner is obligated to walk away from the property with no compensation. This is where the patient investor can realize a significant gain in the property value as they become the fee simple owner of the property.

The example of one of my real estate friends' clients in Hawaii really helps to understand how this works. His client purchased a home in which the client owns several fee simple units in a building, the units have had solid rental income, and the properties have appreciated nicely. Unfortunately, they were recently notified of a $30,000 assessment on each unit for necessary capital improvements of the building.

As his clients were getting older, they are also getting tired of managing the units and finding new tenants almost every year. So, his clients recently purchased the leased-fee interest in another building because of the low acquisition cost, stable income, potential appreciation, and ease of ownership. They were looking for something in the $300,000 price range and nothing in that fee-simple price range in the metro Honolulu market appealed to them. They could, however, buy the leased-fee interest in a 2-bedroom condominium for $310,000. The current fee simple price for 2-bedroom units in the same building is around $600,000.

The terms of the lease provided for the current annual lease rent of $10,000 and an increase in lease rent for the last 10 years of the lease, which expires in 2032. The annual lease rent is not quite at the cap rate they were looking for, but when they explored the potential overall yield of the property after reversion in 2032 and considered the ease of owning Leased fee interest in property, they decided to move forward.

Between now and 2032, the lease rent will increase one more time and their return on investment will improve. When the property reverts, they will have the fee simple interest in a property that should be worth almost double the initial investment of $310,000. As I mentioned earlier, the current market value of similar fee simple properties is around $600,000. In the unlikely event values remain stagnant over the next 12 years, they will still gain $290,000 in addition to the lease rent they have collected over the 12 years of the remaining lease term. If property values continue to rise, as they always do over time, then the value gained at reversion will be even greater.

Importantly the terms of the lease also assign who pays for the various expenses and carrying costs of the property. The leasehold owner is responsible for property taxes, maintenance fees, and any assessments during the lease. If there is a $30,000 assessment on this unit, his clients did not have to worry about it. They also do not have to worry about the work to find tenants during the term of the lease. The leasehold owner is responsible for the monthly lease rent whether they are an occupant, or they are renting the property to a tenant.

During their due diligence, the question of missed lease payments did come up. There is always the possibility that a leasehold owner either decides not to pay the lease rent or cannot pay the lease rent. That can cause some extra-legal expense and hassle for the leased-fee owner, but it can also create a situation where the reversion is accelerated, and the leased-fee owner becomes the fee simple owner much sooner than the lease expiration.

Leased Fee-interest ownership is great for investors looking for a stable long-term investment a secure rising revenue stream until the lease ends and the reversion provides the big return. This is ideal for younger investors who do not have as much to invest and have the luxury of time on their side. This can be a great asset for retirement planning, especially if the leased-fee interest is purchased in a self-directed Roth IRA. It can also be a great asset for long term estate planning. A leased-fee property purchased for the benefit of young children now can help to fund their college tuition or even become a future home after reversion.