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# LEASEHOLD PROPERTY: ATTRACTIVE INVESTMENT OPPORTUNITIES WITH DIVERSE RISK DRIVERS

The German leasehold law became effective on 15 January 1919, celebrating its centenary back in 2019. The original intention was to deal with scarce living space in rural areas, as a result of returnees and refugees during and after the First World War. Heritable building rights would enable people with little income to own their own homes and prevent land speculation. One hundred years after its invention, the most common use of leasehold is still to build residential property. However, the concept also finds its application in commercial real estate. The authors discuss the investment opportunities offered by leaseholds to several types of investors with different risk appetite. Red.

The main idea of a leasehold is to split ownership of the land and the property built on it (see Figure 1). The owner of the land, as a so-called lender of heritable building rights, grants the tenant 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 leasehold as such offers more opportunities than affordable housing only. It allows for opportunities for several types of investors with different risk appetite. For example, investing in property built on the leased land exposes investors to commercial real estate risks, which require management of tenants as well as maintaining the condition of the property. On the other hand, investing in the land and leasing the right to build a property presents a lower-risk profile due to stable cash flows supported by strong security packages granted by the legal framework and contractual rights.

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Further, a property owner, renting out the property built on the plot under the leasehold can deduct the leasehold payments from his taxable income, while tax-relevant write-downs on the land itself would not be not possible. And finally, 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.

## 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 (see Figure 2).

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.

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 and public charges. Also, required capital expenditures in order to preserve income generation of property (e.g. operating expenses and maintenance costs) rank senior. 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.

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. The "Heimfall" however is 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.

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.[1)]

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.[2)]

## Forced sale starting from a clean slate again

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.

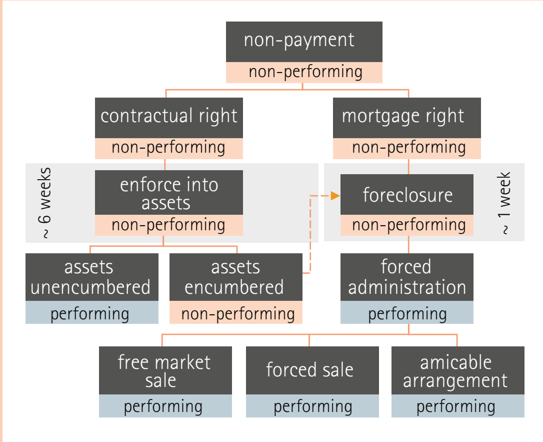
The owner of the land can refuse the buyer if this (veto right) is recorded into the land-register. Such veto right also exists with respect to an orderly sale, to protect the landowner partially against unwanted strategy changes, unskilled management or riskier owner structures in general. Recovery 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.

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.

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 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.

**Figure 2: Legal options**

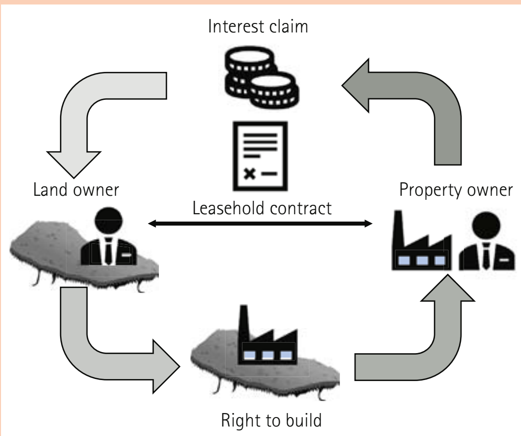



Source: Scope Ratings

## Long risk horizon partly relievable

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 cashflow, as well as the structural mitigants, such as reserves or guarantee providers.

**Figure 1: Hereditary building rights (exemplary)**




Source: Scope Ratings

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 generally seen 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.

Due to the long risk horizon, Scope's analysis reflects a stressed through-the-cycle performance of the property. In light of the long risk horizon the Agency focuses its analysis on the sustainability of the property's location and condition. Elements of the leasehold agreement are reviewed to ensure that the property will remain at least at its current condition, while any major change that might affect the property's use should be subject to the landowner's approval.

A liquidation scenario is seen as an unlikely event due to the superior treatment of the leasehold under a forced administration, which is seen 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.

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

Footnotes

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