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EXCLUSIVE

The Art of Real Estate Fractionalization

By Joseph Ori, executive managing director, Paramount Capital Corp. | Commentary

Fractionalization can be an attractive financial engineering program; however, successful implementation depends on the specific property, capital markets and cap rates, says Ori.

WALNUT CREEK, CA—Fractionalization of **commercial real estate** refers to the process of carving up a real estate asset owned in a fee simple estate into separate estates including a leasehold estate of the land and a leasehold estate of the building, with the objective of creating value of the individual claims on the realty that is greater than the value of the property as a whole. The process has been around since the early 1900's and was successfully used by real estate icons of that era, **Harry Helmsley** and **William Zeckendorf**.

Mr. Helmsley's most famous fractionalization was the acquisition of the **Empire State Building** in 1961 for $65 million. The building was fractionalized into a **sale-leaseback** of the land, a master net lease of the buildings operations and a new mortgage of $20 million from **Prudential Insurance Co.**

Can a shopping center or office building be successfully fractionalized in today's market so that the sums of the parts are greater than the whole? I say yes, but it depends on the specific property, sales market and location. To illustrate the process, we will use the example of a major hi-rise office building located in the Financial District of San Francisco, CA and owned by a major institutional investor.

The building is an unlevered, class B+ property in an A location, 97% leased, 500,000 rentable square feet on 1.5 acres or 65,340 square feet of land. The NOI is $15 million or $30-per-square-foot net. The property could be sold at a 7% cap rate on the NOI of $15 million or a price of $214 million and $428-per-square-foot. In this market sale, the seller receives the sales price of $214 million ignoring any sales and closing costs.

In a fractionalization structure, the property is apportioned into three tranches, a sale leaseback of the land, a master lease of the operations and then a sale or refinance of the property. The first step is a sale leaseback of the 1.5 acre site. Land in the Financial District of San Francisco is very expensive and in high demand and it is estimated that the land could be sold in a 99-year sale leaseback at an initial price of $750-per-square-foot or $49 million (65,340 square feet times $750-per-square-foot). Annual payments under the ground lease will begin at a 5% cap rate or $2.45 million per year for the first five years increasing 5% every five years thereafter. The purchaser of the land would most likely be an institutional investor or sovereign wealth fund that is seeking a secure long term bond type investment in a 24-hour city like San Francisco and therefore would accept the low initial rate of return of 5%. The closing proceeds to the building owner and seller lessee (ignoring sales and closing costs) will be $49 million, however they would be liable for the future annual lease payments, beginning in year one at $2.45 million.

The second part of the fractionalization would be a master lease of the building operations. Currently, the building is 97% leased and produces an NOI of $15 million. The property owner will master lease the building for 99 years at a beginning annual rent of $14 million or $1 million less than the current NOI. The master lessee will collect $15 million in net rent from the underlying tenants and pay the master lessor $14 million in annual rent, thereby, earning the lease spread over the term of the lease. The master lease rent will increase 5% every five years of the lease. With the ground and master leases in place, the owner could sell or refinance the building and for this analysis we will assume a market based sale of the building subject to the master lease and ground lease. The owner would sell the building subject to the master lease of $14 million and subject to the ground lease with a $2.45 million annual payment or a net cash flow of $11.55 million ($14 million master lease less $2.45 million ground lease). The net cash flow of the building would be considered very secure as it is backed by the master lease from the institutional investor owner, is a long term fixed bond type return and could be sold at a cap rate of 6% or a price of $192 million.

A comparison of the sales proceeds and cash flow of the market sale versus the fractionalization is shown in the table below:

As shown above, the fractionalization program produces $28 million more in gross proceeds to the property owner plus the future spread on the master lease. In this example, fractionalization produces a higher return and cash proceeds as compared to a sale of the freehold estate. Even though fractionalization is a convoluted transaction with substantial risk, investors that own high quality buildings in core markets should perform a review of their portfolios to see if any properties qualify for this structure. Fractionalization can be an attractive

(millions)

Sale of the Building	Amount	Fractionalization of the Building	Amount
Sale Proceeds	$214	Land Sales Leaseback	$49
		Sale of Building	$192
		Spread on Master Lease (Year 1)	$1
Total Proceeds	$214	Total Proceeds	$242

financial engineering program; however, successful implementation depends on the specific property, capital markets and cap rates.

Joseph Ori is executive managing director of Paramount Capital Corp. The views expressed in this column are the author's own.

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