The Ins and Outs of Joint Partnerships

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Point/Counterpoint:
Investor and Sponsor/Developer In Real Estate Joint Ventures

The Perspectives from Each Side of the Deal on the Big Issues in Negotiating Joint Venture Agreements

***The Basics*:**

- Deal Structure:
  - Typical joint venture structure: a partnership between a Sponsor/Developer that develops or operates the Project and an Investor (institutional investor, private equity fund or high net worth individuals) that invests a substantial amount of the capital required for the Project.
  - Joint Venture Agreement in the form of a Limited Liability Company Operating Agreement and a Development or Asset Management Services Agreement.
  - Classic "90/10" deal, where Investors bring around 90% of the required equity to the deal and the Sponsor/Developer contributes around 10% of the required equity.

***The Basics*:**

- General Economic Expectations:
  - Investor is expecting a Preferred Return: a rate of return on the capital contributed by the Investor that has priority over the initial rate of return paid to the Sponsor/Developer.
  - Sponsor/Developer is expecting a Promoted Interest and fees:
    - Initial smaller capital account/membership interest is increased after payment of Preferred Return to Investor so that Sponsor/Developer gets a larger share of net profits.
    - Various fees for operational aspects of Project are paid to Sponsor/Developer.

The Basics:

- Basic Risk Allocations:
  - Sponsor/Developer is going to take on the risk of providing the warm body for either a recourse or limited recourse guaranty on the debt for the Project.
  - Sponsor/Developer is going to be liable for certain types of cost overruns.
  - Investor and Sponsor/Developer are both going to be liable for their respective capital contributions, which may be phased over the course of the Project.

The Big Issues:

- Getting together:
  - What is the Investor looking for in a Sponsor/Developer partner?
  - What is the Sponsor/Developer looking for in an Investor partner?
- Getting the money in – Capital Contributions.
- Who Gets Paid What and When – the Waterfall of Distributions.
- Fees for the Sponsor Developer – the Lightning Round.
- Breaking Up is Hard to Do – Getting out of the Deal – Buy/Sell, Buyouts and Selling the Project.

Getting Together:

- What is the Investor looking for in the Sponsor/Developer partner ?
  - Reputation in the market.
  - Experience with product type.
  - Track record in successfully completing similar Projects.
  - Infrastructure – sufficient and quality team to undertake Project.
  - Relationships in the market – ability to get approvals, permits, deal with contractors and subcontractors.

Getting Together:

- What is the Sponsor/Developer looking for in an Investor partner ?
  - Money.
  - Reputation in the capital markets.
  - Ability to work with Sponsor/Developer.
  - Understanding of product type and the development/ construction process.
  - Willingness to pay fees and give Sponsor/Developer a high probability of getting the bonus round to get paid Promoted Interest.

Capital Contributions
Getting the Money into the Deal:

- The importance of the Project Pro-Forma:
  - In order to assess capital needs of the Project, the Sponsor/Developer needs to create realistic financial projections, project budget and expected return analysis for the Investor.
  - What goes into that process?
  - What does the Investor look at in reviewing the Project Pro-Forma presented by the Sponsor/Developer?

Capital Contributions
Getting the Money into the Deal:

- Establishing the Capital Accounts:
  - Each party's Capital Account will be the basis for calculating the returns (Preferred Returns and Promoted Interests) for the deal.
  - Will be scrutinized by the lender to make sure the deal is adequately capitalized.
  - Obviously, will be the seed money to pay for land, hard and soft construction costs, and all other costs of the deal not covered by the debt.

Capital Contributions
Getting the Money into the Deal:

- Capital calls for future capital needs vs. Cost Overruns:
  - Typically, the obligation to pay of cost overruns (major variations from the Project Budget) fall on the Sponsor/Developer.
  - Is that fair?
  - Sponsor/Developer:
    - Major unanticipated changes in the market for materials, labor or other force majeure affected items.
    - Changes required by governmental authorities, changes in law all could add unanticipated costs to the cost of the Project.
  - Investor concerns :
    - Sponsor/Developer just screws up.
    - Changes in the field.

Capital Contributions
Getting the Money into the Deal:

- Failure to make a capital contribution - dilution vs. member loan:
  - Dilution: if one party fails to make its capital contribution or fails to make a future Capital Call, then the non-defaulting member can make the contribution on behalf of the defaulting member, receive additional membership interest, on a multiple basis (2 for 1 or 3 for 1) resulting in the defaulting member's interest being diluted.
  - Member Loan: if one party fails to make its capital contribution or fails to make a future Capital Call, then the non-defaulting member can make a loan to the Company at a premium interest rate, the repayment of which Member Loan has a higher priority on the distribution waterfall than pretty much anything else.
  - Which remedy is preferable?

Waterfall of Distributions:

- Net proceeds:
  - Operations: remaining funds after collecting all rents and payment of all expenses:
    - Debt service
    - Real estate taxes
    - Operating Expenses and Insurance
    - Fees
  - Capital Event – Sale or Refinancing: net proceeds after paying off debt and, in the case of a sale, other unpaid costs of the Project.

***Waterfall of Distributions*:**

- The Waterfall:
  - Payment of Member Loans, if any.
  - Return of Capital, whether initial capital contributions or a loan made by a member to cover a capital contribution not made by another member.
  - Payment of Preferred Return on an IRR basis with possible multiple hurdles:
    - A 10% IRR as a first hurdle.
    - A 15% IRR as a second hurdle.
  - Payment of return on a Promoted Interest basis to the Sponsor/Developer.
  - Distribution of leftovers taking Promoted Interest into account.

Waterfall of Distributions:

- Why is the Investor entitled to the Preferred Return at the IRR's it expects?
  - Investor is contributing the majority of the capital for the Project.
  - Investor is depending on Sponsor/Developer to get the job done, using Investor's money, with very little control on the part of Investor, so the risk factor for Investor's capital contribution to the joint venture needs to be accounted for and paid for.
  - Certain amount of economic incentive for Sponsor/Developer – need to make the Preferred Return hurdles to get to the Promote. Sponsor/Developer is going to work hard to make the Project successful and get to the bonus round.
  - Current expectations for Preferred Returns
- Sponsor/Developer's position.
  - Does that all make sense?
  - Where is the value for Sponsor/Developer?

Waterfall of Distributions:

- Promoted Interest to Sponsor/Developer – getting to the bonus round:
  - Only happens once member loans are paid and Investor has been paid its Preferred Returns.
  - Once previously levels on the waterfall are paid, instead of the 10% of net proceeds from income or a capital event (which would be Sponsor/Developer's share based on its Capital Account), Sponsor/Developer is paid a higher percentage of net proceeds.
  - Stated another way, Sponsor/Developer's interest is "Promoted to a higher rank" and paid at a higher percentage.
  - Impact of various fees being paid to Sponsor/Developer during the course of the Project.
  - Current expectations for Promoted Interests.
  - Investor's position.
    - Does that make sense?
    - Where is the value for the Investor?

***Waterfall of Distributions*:**

- A footnote on financial reporting and record keeping:
  - Obligation to maintain financial records and report to the Investor is on the Sponsor/Developer.
  - Oftentimes Sponsor/Developer complains about onerous reporting requirements.
  - Keep in mind that many disputes between joint venture partners are over Preferred Returns and payments of Promoted Interests which are completely dependent on a factual analysis of the financial records of the deal.
  - Very important for Sponsor/Developer to be scrupulous and thorough in record keeping as those records will be the basis to prove up what Sponsor/Developer (and Investor) are entitled to in the deal.
  - Spend the money on good accountants and good internal record keeping procedures to avoid conflicts or to have the best evidence to support a claim in the event of a dispute.

Fees Paid to Sponsor/Developer – A QUICK LIGHTNING ROUND:

- Sponsor/Developer Fee.
- Asset Management Fee.
- Guaranty Fee.
- Sponsor/Developer's Related Business/Affiliate Fees:
    - Contractor for the job.
    - Property management.
- Leasing or sale commissions.

Breaking Up is Hard to Do – Getting Out or Ending the Deal:

- Buy/Sell clause:
  - The offering party makes an offer to buy or sell to the non-offering party for a stated price.
  - The non-offering party can either:
    - Accept the offer and buy or sell to the offering party at the stated price, or
    - Decide that it wants to buy or sell from/to the offering party at the stated price.
  - This is sometimes called a "Russian Roulette" clause as it is possible that the non-offering party will decide to flip the offer on the offering party.
  - This is intended to make the offering party think carefully about the price at which it is offering to sell/buy as it may have to accept that same term back if flipped by the non-offering party.
  - Investor's perspective on the classic Buy/Sell ?

Breaking Up is Hard to Do – Getting Out or Ending the Deal:

- Pre-agreed Buy Out Process:
  - Inherent tension between Sponsor/Developer and Investor.
    - Sponsor/Developer wants to get to the bonus round, which many times means selling the Project.
    - Investors like the Preferred Return and consistent cash flow as a return on capital invested.
    - Oftentimes, Investors do not want to sell as quickly as Sponsor/Developers do, hence the inherent tension.

Breaking Up is Hard to Do – Getting Out or Ending the Deal:

- Pre-agreed upon buy out process helps resolve that tension.
  - Once Project reaches stabilization, then Sponsor/Developer can put its membership interests to Investor at a predetermined price.
  - Oftentimes the price is calculated as net equity value, based on appraised value (appraised value, minus debt).
- Perspectives on Buy Out Process:
  - Investor
  - Sponsor/Developer


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