JOINT VENTURES

by

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Joint Ventures

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Types of Joint Ventures

Equity Financing Joint Ventures

- JVs for Development
- JVs for Recapitalization of Maturing Debt
- JVs for Acquisition Financing for Operating Property

Strategic Joint Ventures

- JV between landowner and developer
- JV between not-for-profit sponsor and for-profit developer
- JV between equal parties/pro rata investors

Equity Joint Ventures in the Capital Structure

Typical Capital Structure in Operating Property

- Senior Debt – Mortgage and Mezzanine (loan to value) – 60-75%
- JV Equity Requirement – 25-40%
  - Financial Member Equity Share - 70-90% of cash requirements
  - Sponsor /Operating Member Equity Share – 10-30% of cash requirements, guaranties, existing equity on recap

Typical Capital Structure in Development Project

- Senior Debt – Mortgage and Mezzanine (loan to cost)– 65-85%
- JV Equity Requirement – 15-35%
  - Financial Member Equity Share –75-100% of cash requirement
  - Sponsor/Operating Member Equity Share– <10% of cash requirement; land, entitlements, development fees, soft costs, guaranties

Structuring the Right Deal

- A Joint Venture is a Marriage
- The JV Agreement is both the Pre-Nup and the Pre-negotiated Divorce
- Keys to Success Are:
  - Choosing the Right Partner
  - Alignment of Interests Throughout the Life of the Membership
  - Allowing Each to Have a Voice in Management and Controls Commensurate with the Interests of Each and with Business Operating Efficiency of JV
  - Transparency in Financial Matters
  - Fiduciary Responsibility to the Partner – Putting the Interests of the Company Before the Interests of the Individual Partner
  - Process for Dispute Resolution
  - Commitment to Mutual Success

Choosing the Right Partner

- Choosing a Financial Partner: Issues for Consideration
  - Investor Return Thresholds
    - IRR Driven
    - Total Return Driven
  - Investment Time Horizons
    - Exit/Liquidation Date on Fund
    - "Patient" Capital of Insurance Companies, High Net Worth Private Investors
  - Risk Tolerance and Investment Parameters
    - High Risk, High Yield
    - Conservative Risks and Rewards
  - Asset Class Allocation
    - Development
    - Operating Property Asset Classes – Core, Core Plus, Retail, Industrial, Multifamily
- Choosing a Sponsor Partner: Issues for Consideration
  - Available skills and staffing; Competing projects and exclusivity

Characteristics of Equity JVs - Organization

- Types of Organization
  - LLCs – Delaware or Local Law
  - Each "Borrower Entity" Structured as a Single-Member Entity with SPE Manager
  - "Real" JV usually up one level from property (or two, if mortgage and mezzanine debt)
  - LPs – characteristic JV format of funds
- Management Structure of Equity JVs
  - Operating Member as Managing Member
  - Financial Member as Co-Managing Member or Non-Managing Member with Major Decision Rights
  - In Partnerships, Operating Partner as General Partner
  - Financial Partner as Co-General Partner or Special Limited Partner
  - Executive Committee Role

Characteristics of Equity JVs – Capital Contributions

- Initial Capital Contributions
  - Cash
  - Land or In-Kind contributions – Valuation, Built-In Gain
  - Conditions to Equity Pay-In
- Additional Capital Contributions
  - Mandatory Additional Capital – limited purposes, capped amounts
  - Permissive Additional Capital – who calls, for what purposes?
  - No third-party beneficiary of overcall obligations
- Guaranty Capital Contributions – for Loan Guaranty Liability
  - Environmental
  - Recourse-Carve-Out “Bad Boy”
  - Completion and Cost Overrun
  - Parent Company Obligation to Fund Guaranty Capital Contributions

Characteristics of Equity JVs – Capital Contributions cont’d

- Failure to Make Additional Capital Contributions
  - Punitive Remedies should be only if Mandatory Capital (including mutually agreed capital calls)
  - Loan to Defaulting Member
  - Dilution of Defaulting Member Percentage Interest with Penalty Formula: Contribution Interests vs. Distribution Interests
  - Loss of Voting Rights after Default
  - Loss of Voting Rights if dilution below Specified Percentage Interest
- Removal of Management Role after Dilution Below Specified Percentage Interest
  - Lender and Other Consent Considerations in Replacing Managing Member
  - Substitution of Loan Guarantor or Back-Up Indemnity to Removed Guarantor
- If Default In Permissive Capital, Remedy Should Be Priority Loan To Membership

Characteristics of Equity JVs – Distribution Waterfall

- First, Priority Loans or Default Capital Repaid with Interest - Repayment from JV or from Defaulting Member
- Second, Additional Capital ("New Money") with Preferred Return Paid
- Third, Initial Capital with Preferred Return Paid, Until First Hurdle Rate
- Fourth, Subordinated Fees, Excess Land Value, Development Cost Overruns or Other Subordinated Additional Capital Contributions Repaid, With or Without Return
- Fifth, Initial Promote Structure of Operating Member Paid After Initial Hurdle Return on Investor Capital – e.g., 15% after a 15% IRR
- Sixth, Additional Promote Structure of Operating/Developer Member Paid After Subsequent Hurdle Returns on Investor Capital
- Seventh, Residual Percentages

Characteristics of Equity JVs – Responsibilities

- Responsibilities of Managing/Operating Member
  - Prepare Budgets and Business Plan
  - Arrange Financing
  - Contract for Services on Behalf of Venture
  - Originate Transactions for Venture – Additional Acquisitions, Sales
- Affiliate Contracts –
  - Fair and arms'-length terms
  - Approval and Enforcement Rights in Non-Affiliated Member
- Accounting, Books and Records, Tax Matters

Characteristics of Equity JVs – Decision-Making

- Unanimous Consent for "Organic" Decisions
  - Merger, Dissolution, Amendment of Structure, Tax Treatment, Additional Members
  - Bankruptcy – Control Must Be in Hands of Non-Recourse Carve-Out Guarantors
- Supermajority/Non-Managing Member Consent for "Major Decisions"
  - Capital and Operating Budgets, Business Plans
  - Major Leases
  - Financings, Recapitalizations
  - Sales of Property or Major Interests
  - Development Project: Key Development Decisions – Program, Architect, CM, Financing, Sales/Leasing Program, Budget and Amendments
  - Capital Calls
- Managing Member Day-to-Day Operational Controls

Characteristics of Equity JVs – Guaranties

- Guaranties to Lender – Which Member Gives?
  - Guaranties which are JV risks
    - Environmental
    - Other Property-Related
    - Principal, Financial Guaranties
  - Guaranties which are Risks of One Member
    - Development Guaranties – Completion and Cost Overrun
    - Non-Recourse Carve-Out "Bad Boy" Guaranties
- Contribution and Indemnity Between Members Where One Gives Guaranties to Lender
- Guaranties from One Member to Another
  - Development – Completion and Cost Overrun Guaranties
    - Structure and Recovery of Cost Overrun Capital – Alignment of Interests
  - Guaranteed Investment Return

Characteristics of Equity JVs – Resolving Deadlocks

- Buy-Sell
  - Triggering cause or no cause
  - Lockout period – stabilization, completion of project
  - Lender concerns
  - "Leveling the Playing Field" Between Operating and Financial Member with Extended Exercise and Closing Time Frames, etc.
- Single Member Override on Specified Decisions
- Forced Sale of Asset
- Does Arbitration or Third-Party Decision Ever Make Sense?

Characteristics of Equity JVs – Exit Strategies

- Sales of Interests to Third Parties with ROFR In Non-Transferring Member
  - Permitted Transfers
  - Sales of Upper Tier Interests in Member Entities
- Forced Sale of Property with ROFO In Non-Selling Member
- Drag Along and Tag Along on Interest Sales
- Valuation Effects on Interests Being Sold – Sale of Interest vs. Sale of Project
- Put Rights
- Lock-Out Period – Stabilization, Completion of Project
- Lender Issues

Characteristics of Equity JVs – Fees

- Development Fees
- Property Management and Leasing Fees
- Asset Management Fees
- Partnership Management Fees
- Expense Reimbursement
- Other Service Fees – Acquisitions, Debt Placement, Construction
- Fee Subordination to Loans, Preferred Returns
- Fee Sharing Among Members

Strategic Joint Ventures

- JV between a Not-for-Profit Institution Selling Underutilized Land to Developer in Return for Cash and New Facility as Part of Larger Development
  - Not-for-profits own valuable land in desirable locations, often lack capital for required capital improvements
  - Seek to unlock land value with JV transaction with developer to develop new facility for NFP in tandem with on-site commercial development
- Structuring the Transaction
  - Recognition of Division of Expertise and Responsibility
  - Harmonizing the Divergent Interests and Risk Tolerances of the Members
  - Clear Cost Allocations, Financial Accountability and Transparency
  - Taking Advantage of NFP Tax Exemptions
  - Completion Guaranties and Security

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