

Strategies For Successful Joint Ventures

Strategies for a successful courtship and marriage in the real estate world.

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Over the past few years, sponsors (investors, operators, developers) have had no difficulty executing on acquisitions, new developments and redevelopments on their own. In fact, even less qualified sponsors with speculative projects were able to minimize capital investments through high leverage. As a result, many sponsors avoided diluting their ownership position via a joint venture structure and pursued financially engineered solutions to meet their capital needs. However, with the current credit market correction and its resulting impact on the real estate market (conservative underwriting, increased equity and balance sheet requirements, focus on experienced sponsors and sound projects) together with increased deal complexity, we expect to see an increase in the volume of joint ventures being completed in the market.

WHAT IS A JOINT VENTURE?

A joint venture is not a conventional partnership, but rather an agreement by two or more parties to carry out specified responsibilities and obligations to achieve certain objectives. It is a legal organization that takes the form of a short-term partnership in which the persons jointly undertake a transaction for mutual profit. Distinguishable from a partnership by narrowness of purpose and scope, joint ventures can be for a specific project or for a continuing business relationship. Typical reasons for the formation of joint ventures include:

Capital Partner — the most common joint venture structure is that in which a sponsor secures a money partner that puts up the entire cost of development or acquisition (debt and/or equity) and in return receives a preferred return and an ownership position. Structures range from 50/50 arrangements to those with cash flow/capital event sharing based on a pari passu structure with the developer receiving a promoted interest. Depending on the characteristics and risk/return profile of the asset, capital partners will

range from institutional and offshore core focused investors to entities that can assume a higher degree of risk (REITs, hedge/opportunistic funds, other developers and private investment groups). While preferred equity investment structures can provide required equity on a more passive basis with less upside participation, a joint venture partner can accept more risk (guarantees/liabilities, leasing, pre-development, construction, etc.) in exchange for shared control and ownership.

Development Partner — two common uses are where: 1) a smaller developer (pursuing a larger project) brings in a larger developer to provide development expertise, tenant relationships, a required resume/balance sheet and/or capital, or 2) a property type focused developer brings in one or more outside developers to develop the alternative property types for a mixed- or multi-use project. Given the independent nature of most developers, a joint venture arrangement between two different property type developers poses its own set of challenges.

Land/Project Partners — to limit upfront project acquisition costs or high sale price expectations, a sponsor will enter into a joint venture with an existing land or building owner (redevelopment projects) where the project is contributed or sold to the joint venture at an economically viable basis in exchange for an ownership stake in the venture. This structure is sometimes the best option for sellers who cannot achieve their targeted pricing in the current market. The sponsor secures the required financing (with or without the contributing entities' balance sheet) and develops/redevelops the project.

Credit Enhancement — situations where a JV partner puts up its financial strength and credit rating in the form of a standby commitment, loan guarantee or other form of credit enhancement and in return receives a share of cash flow and capital event proceeds.

Whatever the reason for a joint venture, there are a variety of factors to consider.

JOINT VENTURE PARTNER CONSIDERATIONS

Joint ventures are complicated transactions that may take an inordinate amount of time to negotiate and complete. This is a key consideration when dealing with a time sensitive deal. Joint ventures are not appropriate for all sponsors and typically involve complex documentation and sharing of profits/ownership/control. In determining a joint venture strategy, the sponsor/developer should first analyze the following:

- **Sponsor Self-Assessment** — what is the primary need for a joint venture partner and what are the alternatives to a joint venture structure. In addition, what are the sponsor's exact goals and objectives? The most important aspect of a joint venture is procuring a partner with similar goals and objectives.
- **Project characteristics** (deal size, location, asset type, investment strategy, etc.) and risk / return thresholds will determine what type of partner would be the most appropriate and most interested for the given opportunity.
- **Risk/Return thresholds** — investors each have different return thresholds based on the risk they are willing to take. Understanding the project's risk/return profile will help narrow the search and help determine whether there is adequate profit potential for the sponsor and partner. With the increase in exit cap rates, the profit margins have compressed and the project might not be financially viable in the current market.
- **Timing** (initial reaction time and anticipated hold) — if the viability of a project depends on quick execution, a private market/entrepreneurial entity (as opposed to an institution) might be the best choice. In addition, a longer investment period might lessen potential interest.
- **Control Requirements** — What level of control is the sponsor willing to share? If it is unwilling to be share control and decision making, a joint venture arrange-

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CONSIDERATIONS FOR A JOINT VENTURE

Relationship	The most critical aspect of any joint venture. Determining and assessing mutual goals/objectives, compatibility, synergy, alignment of interests, risk / return thresholds, holding period expectations, conflicts of interest, tax requirements, and legal organization.
Liquidation	What is the method for dissolution of the venture — by vote, term or event?
Determining Ownership Interest	Each party has a differing viewpoint as to their value in the transaction (perceived contribution + risk taken). A number of factors are considered when determining ownership interests: value of contributions, land value (contributed land or sold to venture — tax consequences), unique expertise, capital contributions/credit enhancement and other guarantees, risk, contracts/options, leases/tenant relationships, and financing.
Transfer Rights	Transfer rights must be addressed and include lock-outs/forced sales, rights of first offer/refusal, call/put options, and tag-along/drag-along rights.
Capital	Capital contributions are a very important area to address: capital accounts, contributions (pro-rata or disproportionate), capital calls and unanticipated costs (default/inability to fund and dilution of interest), timing of contributions, and reserves. Capital accounts impact the tax position of each partner and should be carefully structured.
Governance/ Venture Management/ Control	While sponsors dislike sharing or relinquishing full control, joint venturers will at a minimum require that “major acts/decisions” be subject to approval (change in control, substantial capital improvements, additional financing, major contracts and leases, settlement of insurance/condemnation claims, legal action, employing/discharging vendors, capital events, distributions/capital calls and variances beyond agreement provisions, etc).
Resolution of Disputes	Even though a well thought out operating agreement can minimize issues and disputes, they are bound to come up. Disputes can be resolved via the purchase of interests (including reciprocal purchase rights and forced sales), executive resolution, use of specialists and outside advisors, arbitration, or litigation. The best way to minimize disputes is to resolve potential areas for disputes at the outset in the JV agreement. A carefully negotiated agreement will provide the mechanisms to deal with issues or options as they occur in the future.
Distributions & Profit	The economic benefits from the project come in the form of cash flow distributions (preferred returns/excess cash flow), capital events (sale/refinancing), and tax benefits. Cash flows/profits can be funded via preferred/priority returns on a pari passu basis, via promoted interests, and through water fall structures. In addition, priorities to cash flow catch ups (cumulative or non-cumulative) must be addressed.
Fee Structure	Any fees increase the cost of the project and the required income to achieve targeted returns (some operators might choose to secure more upfront fees in exchange for less upside in the project). Typical fees to be addressed include construction management, development, leasing, asset management, property management, acquisition, disposition, legal, financing and guarantee fees.
Liability	Investors will want to see that the sponsor has some “skin” in the game: guarantees (completion and repayment) and shared guarantees. The more liability a sponsor is willing to assume, the higher its economic rewards.
Future Transactions	While a joint venture is focused on a specific transactions, a viable relationship depends on understanding how future transactions will be addressed — right of first refusal on new opportunities (and designated criteria), non-competes, radius restrictions, etc.
Roles/ Responsibilities	To avoid any disputes or dissatisfaction, the documentation must specifically define the various roles of the parties and their accountability including — time commitment, outside ventures, dealings with members/family/affiliates, sponsor personnel and staffing, and performance standards.
Reporting/Audits	The sponsor will be required to provide adequate reporting (with higher requirements coming from institutional partners) for the construction, operating and financial aspects of the property including: development/redevelopment updates, balance sheet, general ledger, cash available for distribution, statement of operations, variance reports, accounts payable and receivable, depreciation/amortization schedules, capital expenditure summaries, rent roll, sales reports, leasing status report, CAM/tax billings, etc.

ment might not be the best option.

- **Contribution** — What is the contribution to the joint venture (capital, unique expertise, relationships, services, financing, below market acquisition costs, etc.)? The JV partner will want to determine whether the sponsor's staff is adequate and is sufficiently experienced. In addition, the partner will want to know that the developer has the financial strength to cover any cost overruns.
- **Value-Add** — To secure the best terms, a sponsor needs to gain as much leverage as possible prior to looking for a JV partner by reducing the project's risk profile (e.g., completed entitlements, pre-leasing), thereby gaining more deal control, and bringing more to the table.

After analyzing the foregoing considerations, the sponsor is better prepared to secure the right partner and the best terms.

THE NEGOTIATING PROCESS

There is no set structure for a joint venture and each is negotiated based on the specifics of the transaction. Obviously, sponsors improve their position by increasing deal control and reducing the

perceived deal risk. Before negotiating an agreement, it is important to understand that both sides have opposing viewpoints and see their position as superior to and more valuable than the other's.

To be successful, the parties must agree on a proper balancing of the risk and benefits for both sides. Each party should approach the JV with specific objectives, a focused negotiating strategy, and operating flexibility. In addition, they should each have an economic incentive for seeing that the project reaches a successful completion. One of the most overlooked areas of a joint venture is the fit of the relationship (see chart on opposite page) as it is a marriage of personalities and interests. Success depends on agreeing on the accountability for the various responsibilities (development/construction, operation, financial), establishing performance criteria and having an understanding of what procedures will be followed if unexpected problems arise. Negotiations typically start with the execution of a basic term sheet followed by a more detailed operating agreement covering the points shown in the chart on page 77.

CONCLUSION

Joint ventures pose numerous challenges and benefits to sponsors. Too often, an entrepreneur's decision to enter into a joint venture arrangement and the procurement of a partner is an expedient rather than a strategic move — done without thorough analysis of the transaction. As mentioned above, joint ventures are complex to structure and anyone considering a joint venture should engage an outside advisor that can not only determine the optimal structure and "best fit" partners but also assist in negotiating the best terms and reviewing the after tax considerations of alternative structures and terms. While many joint ventures begin with a specific project, they can lead to more of a programmatic relationship. **SCB**

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This article originally appeared in *Shopping Center Business*, February 2008.
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