Programmatic Real Estate Joint Ventures

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Introduction

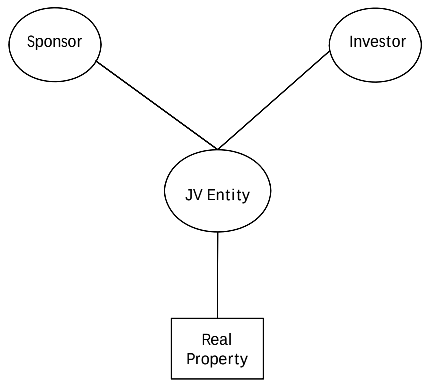
- What are they?
- Structure
- Preliminary questions to be asked by the partners
- Exclusivity
- Economics
- Management
- Events of Default
- Exit rights and lock-up clauses
- Conclusion

What are they?

- Framework for real estate investments between a capital partner ("**Investor**") and a real estate developer ("**Sponsor**") who want to pursue a series of investments based on a single platform
- Comparison to other types of real estate investment vehicles
  - Most basic: the single-property joint venture (the "**Single-Property JV**")
  - Most complex: the discretionary private equity fund (the "**Fund**")

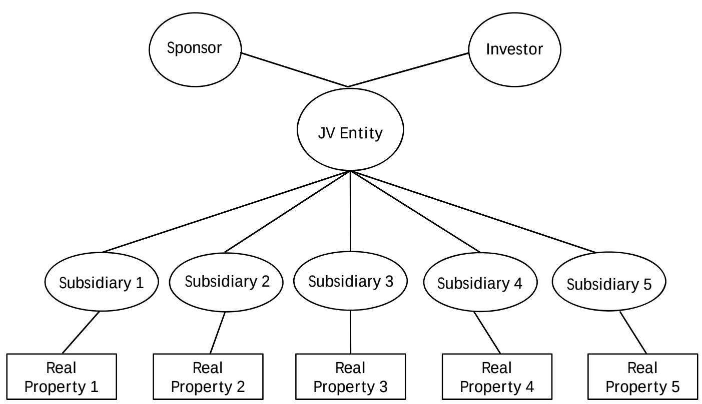
What are they? (con't.)

- Single-Property JV



What are they? (con't.)

- Fund



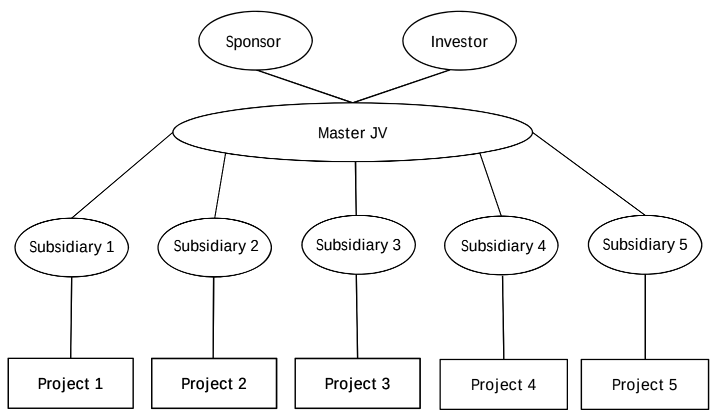
What are they? (con't.)

- The programmatic structure falls between these two types of investment vehicles (the "**Programmatic JV**").
  - Investor is not committed to invest, as in a Fund. However, there is an expectation that Investor will fund real estate investments ("**Projects**") that satisfy certain investment parameters.
  - Sponsor is committed to present all Projects to Investor. However, Sponsor obtains greater certainty of execution than with a Single-Property JV but at the expense of autonomy.
  - Significant disparity: Investor retains autonomy, Sponsor does not.
- Presumed advantages of a Programmatic JV
  - Speed
  - Efficiency
  - Credibility

Structure

- Holding company structure
  - Investor and Sponsor (the "**Venturers**") each own interests in a holding company (the "**Master JV**"), which owns each Project indirectly through a series of subsidiaries.

Structure (con't.)



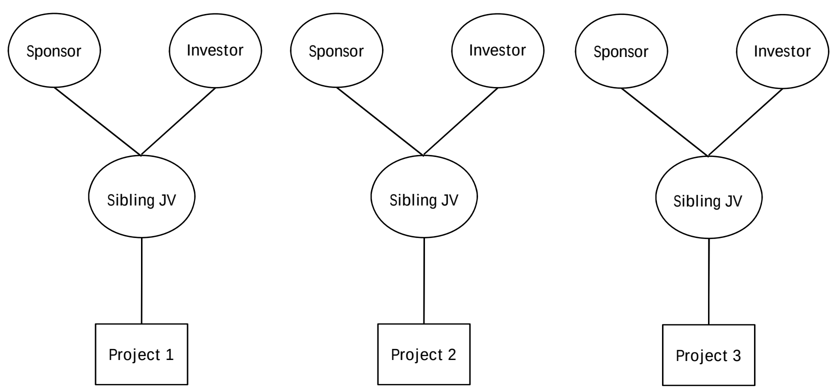
Structure (con't.)

- Holding company structure
  - Investor and Sponsor (the "**Venturers**") each own interests in a holding company (the "**Master JV**"), which owns each asset indirectly through a series of subsidiaries.
  - Advantages
    - Build net worth in Master JV so it can serve as a guarantor
    - Efficiency in documentation
    - Efficiency in formation of entities

Structure (con't.)

- Sibling structure
  - Venturers own interests in individual LLCs ("**Sibling JVs**"), each of which owns a single Project.
    - Contract between Venturers sets forth framework under which they will enter into transactions.
    - Contract obligates Sponsor to present Projects exclusively to Investor.
    - Contract will likely include exhibits with agreed-upon form documentation to be tailored to each particular transaction.

Structure (con't.)



Structure (con’t.)

- Sibling structure
  - Venturers own interests in individual LLCs, each of which owns a single Project.
    - Contract sets forth framework under which Venturers will enter into transactions.
    - Contract imposes some degree of obligation on Sponsor to present Projects to Investor.
    - Contract will likely include form documentation to be tailored to a particular transaction.
  - Advantages
    - Separate accounting
    - Flexibility of terms

Preliminary Questions to be Asked by Venturers

- Investor
  - Sponsor's staff and infrastructure?
  - Influence over hiring and termination of key individuals?
  - Preferential rights?
- Sponsor
  - Limits on Investor’s ability to invest with Sponsor's competitors?
  - Assurance that Investor can move quickly?

Exclusivity

- Investor will usually insist that Sponsor be subject to exclusivity covenants
  - Crucial and heavily negotiated component of a Programmatic JV
  - Potentially good for Investor, who wants to invest a large amount of capital into high-quality projects through a strong sponsor
  - Potentially good for Sponsor, who wants a reliable source of capital
- Issues to consider
  - Length of the exclusivity period: two-to-four years is common
  - Establishing investment parameters (the "**Parameters**")
    - Asset class
    - Geography
    - Dollar amount of required capital commitment
    - Return criteria for Investor
    - Financing parameters
  - Parameters define exclusivity

Exclusivity (con't.)

- Obligations
  - Concerns
    - Investor to Sponsor: "Go look for Projects."
    - Sponsor to Investor: "Look carefully but quickly at the Projects I bring you. And fund them."
  - In general terms, Venturers will agree as follows:
    - Investor will fund a certain amount of equity to Projects that fit within the Parameters. But Investor has no binding obligation to fund Projects – even those that fit within the Parameters.
    - Sponsor will use commercially reasonable efforts to source Projects that fit within the Parameters. Sponsor has a binding obligation to present to Investor all Projects that fit within the Parameters.

Exclusivity (con't.)

- This concept is easy to articulate but harder to implement
  - Timing
    - Can Investor make a quick "yes" or "no" decision regarding a proposed Project?
    - How much due diligence material does Investor require?
  - Expenses
    - At what point do Sponsor's pursuit costs become expenses allocable to a particular Project?
    - How are these costs allocated?
  - Rejected Projects
    - Pure exclusivity?
    - Complete release?
    - Right of first offer?
  - What happens if Investor rejects multiple Projects or if Sponsor fails to source a sufficient number of Projects?

Economics

- Background
  - Two sources of cash proceeds
    - Operating proceeds
    - Capital proceeds
  - Operating proceeds ("**Operating Proceeds**")
    - Payment of daily operating expenses
    - Repayment of loans from one venturer to another
    - Return of additional capital to a contributing venturer
    - Payment of preferred return to Investor
      - Percentage return Investor is to earn on its investment – i.e., "**return <u>on</u> capital**"
      - Distinguished from Investor's recoupment of its capital – i.e., "**return <u>of</u> capital**"
    - Return of initial capital to Venturers
    - Payment of promote to Sponsor
      - Promote = Π interest > K interest (the "**Promote**")
      - Investor: No Promote unless return on and return of capital

Economics (con't.)

- Capital proceeds ("**Capital Proceeds**")
  - Repayment of third-party loans
  - Repayment of loans by one venturer to another
  - Payment of preferred return to Investor
  - Return of initial capital to Venturers
  - Payment of Promote to Sponsor

Economics (con't.)

- The Issue: Is investment performance measured collectively based on all Projects in the Programmatic JV or individually on a Project-by-Project basis?
  - Sponsor: Pay Promote on a Project-by-Project basis
    - Multiple distribution waterfalls: one for each Project
    - Promote distributions isolated
  - Investor: Pay Promote on a portfolio basis
    - Single distribution waterfall: one for the Programmatic JV
    - Promote distributions crossed

Economics (con't.)

- One solution: Bifurcate Operating Proceeds and Capital Proceeds
  - Aggregate distributions for all Projects in a Programmatic JV but bifurcate Operating Proceeds and Capital Proceeds, such that Sponsor receives Promote distributions to the extent Operating Proceeds exceed the preferred return.
  - Potential problem: Projects might collectively yield sufficient Operating Proceeds to exceed the preferred return at times X and Y but insufficient Capital Proceeds to pay Investor its return on and return of capital upon liquidation of the Projects at time Z.
- Another solution: Clawback
  - Pay the Promote as it is earned and without bifurcation.
  - But payment of the Promote is subject to a clawback.
  - Guarantor

Management

- "Major Decisions"
- "Project Major Decisions" vs. "Portfolio Major Decisions"?
  - Sponsor's desire for autonomy at the Project level
  - Line between "Project" and "Portfolio" can be difficult to draw
  - Sponsor's desire understandable. Is it defensible?

Events of Default

- "Project Events of Default" vs. "Portfolio Events of Default"?
  - Sponsor's desire to contain damage.
  - But the line between "Project" and "Portfolio" can be difficult to draw.
  - To the extent lines can be drawn at all, they likely have to be drawn based on culpability of Sponsor.
- Real estate joint venture documents sometimes differentiate among Events of Default.
  - Misappropriation or embezzlement of property, fraud, gross negligence, willful misconduct, or a bankruptcy filing initiated by Sponsor ("**Wrongful Events of Default**")
  - Project's failure to achieve performance benchmarks or Investor's contribution of additional capital in excess of a specified amount ("**Economic Events of Default**")
  - Removal of Sponsor as manager/general partner without cause ("**Discretionary Removal Event**")

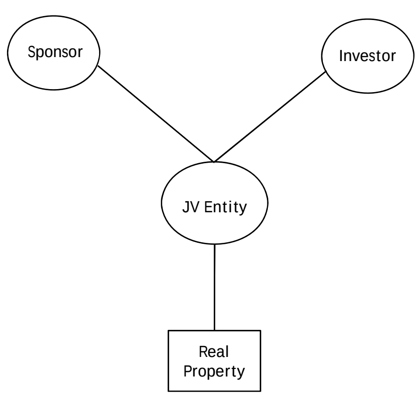
Events of Default (con't.)

- From Investor's perspective
  - Relationship poisoned by a Wrongful Event of Default, even if the bad act could somehow be tied to a single Project.
  - Relationship could possibly survive an Economic Event of Default.
  - Relationship could also perhaps survive a Discretionary Removal Event.

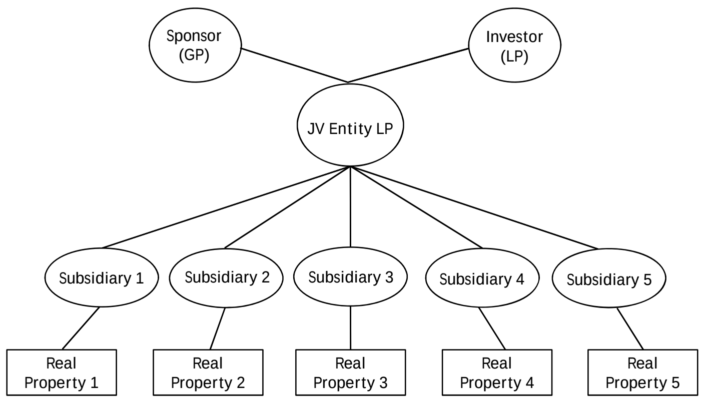
Exit rights and lock-up clauses

- Exit rights
  - Buy-sell
  - Forced sale
- Lock-up clauses
- Do these apply to the portfolio of Projects or to individual Projects?

Single-Property JV



Fund



Key Difference: complexity of implementing exclusivity provision

- Single-Property JV exclusivity provision: As long as Sponsor owns an interest in the Venture, neither Sponsor nor any Affiliate shall develop, own, lease, acquire, manage, operate or otherwise directly or indirectly participate in any Competing Project. "Competing Project" means any property used or intended to be used for retail shopping uses located within the City of [________], State of [________].
- Fund exclusivity provision: During the Commitment Period, neither the General Partner nor any Affiliate shall make any investments consistent with the Partnership's investment objectives for its own account.
- Programmatic JV exclusivity provision
  - What are the investment parameters?
  - How do we determine whether a Project is within those parameters?
  - How do we get to a "yes" or "no" decision by Investor? How long?
  - What happens if Investor says "no" to a Project? To multiple Projects?
  - What happens if Sponsor fails to source Projects?

Conclusion

- There are people with a talent for operating real estate and others who excel at investing in it.
- Each needs the other, and there are several structures by which they can join forces.
- But how good is the Programmatic Real Estate Joint Venture?
  - Thoughts from Investor
    - "I don't know any institutional investor who would do one of these."
    - "Sponsors struggle with the exclusivity provisions. And lack of committed capital."
    - "They sound good. They sell well. They rarely work."
  - Thoughts from Sponsor.
    - "Don't cross the promotes."
    - "Here's a good one. But it doesn't fit in the box."
    - "I don't like the exclusivity provision."
  - Bridging the gap vs. jumping the gap.