WHITE & CASE

Real estate joint ventures: Marriage of equity and expertise

The asset manager's expertise, coupled with the investor's capital, allows both parties to maximise their respective returns

Real estate joint ventures: Marriage of equity and expertise

Real estate joint ventures enable capital providers to have greater control over strategic decisions as to how the property is managed, while asset managers can look to gain a share of the JV proceeds—in addition to their fees. **Victoria Landsbert, Peita Menon** and **James Pullen** of global law firm White & Case explain the key steps to success.

Real estate has always had a strong appeal to investors. Property yields have been outperforming bond equivalents in the Eurozone and UK over the past ten years, allowing investors to gain exposure to an attractive sector with stable returns.

Traditionally, those looking to invest money in the sector take on a passive role and simply inject equity into a real estate project or a listed real estate company without much—or any—say in the way the property is managed.

But forming a joint venture (JV) between an investor and an asset manager may actually be a better option for both parties.

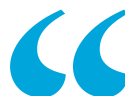
Real estate joint ventures differ from typical JV structures in the respective equity share of the capital that is invested. Most JV structures typically involve a relatively even 50/50 or 60/40 equity split between JV partners.

In a real estate JV, however, it is much more typical for the asset manager—who is providing the real estate expertise—to have a far smaller equity stake, typically 2 to 10 per cent, while the capital provider will contribute 90 to 98 per cent of the equity.

Direct investment into real estate via a JV benefits both the capital provider and the manager. It allows the investor to have greater control over key and strategic decisions relating to the asset while tapping into the expertise of an asset manager with the specialist knowledge in running real estate portfolios. Equally importantly, an equity stake gives the asset manager sufficient 'skin in the game' to have a keen interest in maximising asset returns and making sure the property is being managed in the best possible way.

Structuring a real estate JV

A real estate joint venture (see diagram on page 3) will involve a capital provider who contributes



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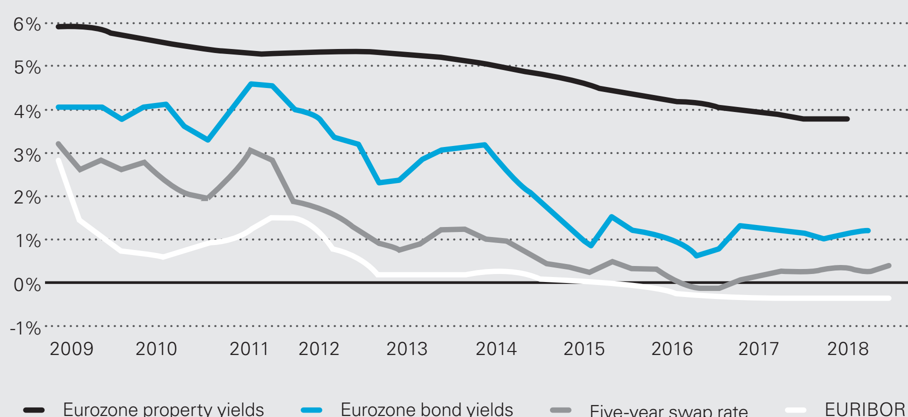
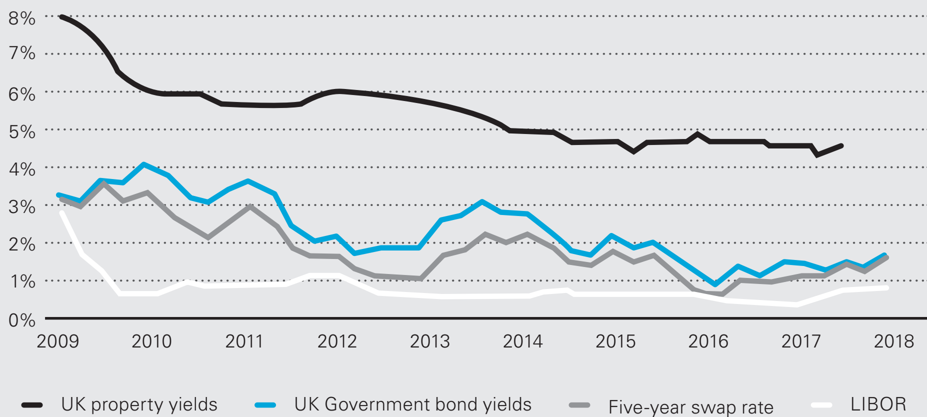
Eurozone property yields and interests rates, 2009 – 2018



Source: CBRE, Datastream, European Central Bank

UK property yields and interest rates, 2009 – 2018



Source: CBRE, Datastream

the vast majority of the equity and an asset manager who invests the remainder of the equity, typically between 2 and 10 per cent.

The 'investor' will typically be structured as a limited partnership managed by a general partner or other tax efficient vehicle. The investor vehicle will contract with the asset manager—owned by the operator investment vehicle—to form the JV entity.

The JV entity will then enter into an asset management agreement (AMA) with the asset manager, either directly or via a subsidiary, and into a property management agreement (PMA), often with a third-party property manager.

The JV entity will own one or a series of SPVs, which will sit directly below the JV entity within the capital structure. The seller of the property or portfolio will then contract with one of those SPVs to transfer the asset to the Propco vehicle.

The investment will often be leveraged with bank debt or

+/-5%

Typical equity contribution by an asset manager in a real estate JV

+/-95%

Typical equity stake of a capital provider in a real estate JV

alternative capital provider debt. That third-party debt is typically invested either at the Propco level or at the level of the corporate vehicle that sits directly above the Propco. The bank debt provider will also enter into a Duty of Care Agreement with both the asset manager and the property manager.

Tax perspective

Tax considerations are critical to the success of a real estate JV and inform a number of important commercial decisions.

From a cash flow perspective, any unexpected tax leakage or liability reduces the return the investor can make from the underlying investment. Consequently, real estate investments typically have tax as a key focus, in particular how best to maintain the tax efficiency of the structure.

But it is a fluid situation. Gone are the days when one structure would be fit for purpose over the medium term. Every JV structure will have to be reconsidered over a shorter, say 3- to 5-year, horizon because the tax landscapes across the world are changing rapidly, and any structure has to be able to adapt to those changes.

From the outset, tax should also be a key consideration in exit planning to allow for an efficient and optimised exit when the joint venture is dissolved or terminated.

The manager's role

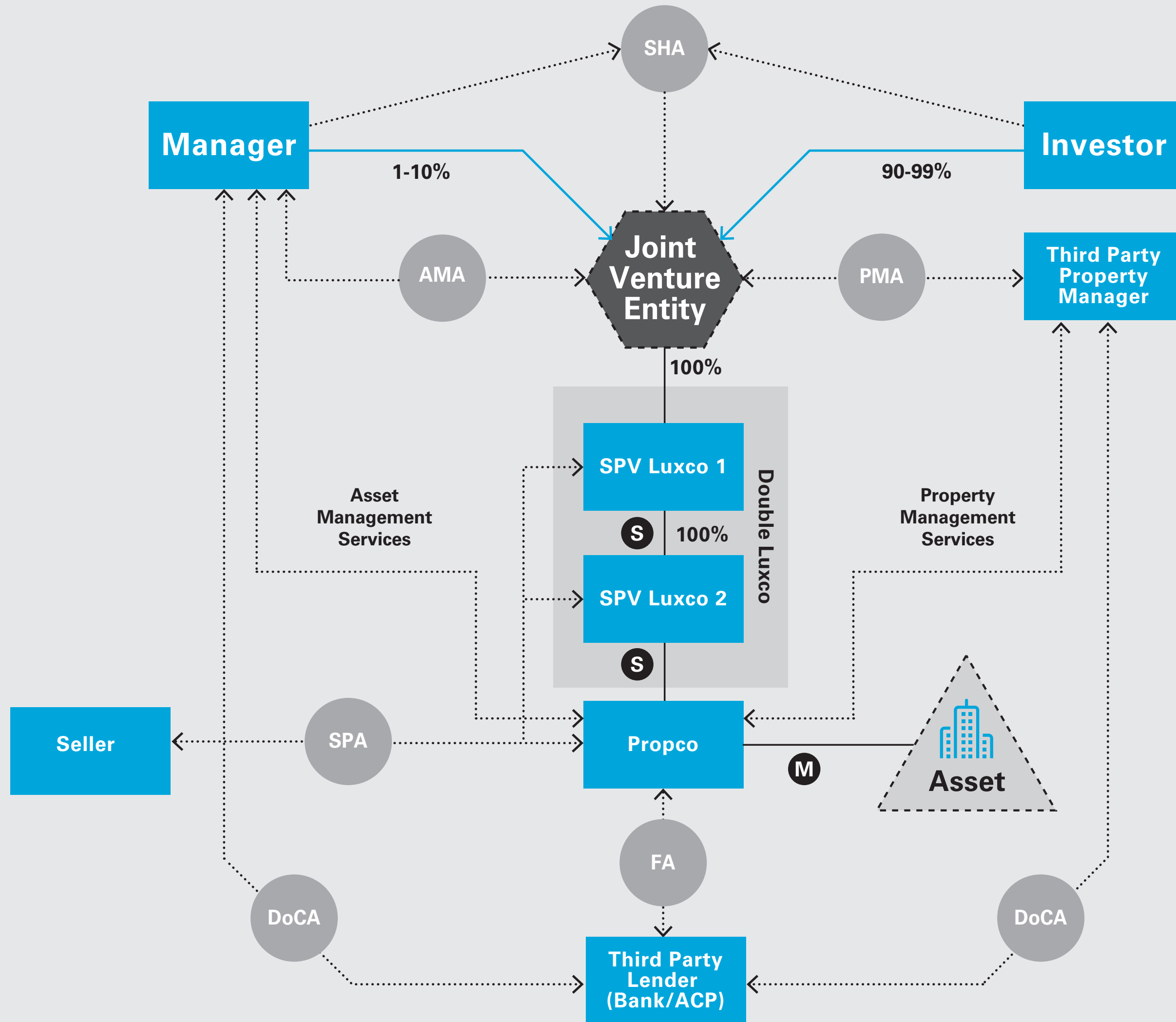
In a real estate JV, the manager plays a pivotal role, so it is particularly important for the investor to choose the right partner. The asset manager's purpose is to provide investment structuring and strategic advice to the JV entity in respect of the asset pool. This will include looking at letting strategy to make sure that the best possible quality of tenants and quality of leases are attracted to the asset portfolio.

This role contrasts with the property manager, who is there to make sure that the property is looked after at a much more asset-specific level and is responsible for the day-to-day liaison with the tenants as regards their needs.

Getting the manager's incentives and fee structure right is critical. Asset managers can typically expect an acquisition or a structuring fee for bringing the asset portfolio to the JV entity. They can also expect a periodic or an annual fee in return for these structuring and strategic services that they're providing. Importantly, in order to reward successful performance, the asset manager can expect to receive a promote fee. All these fees and incentives are very much in addition to any returns the asset manager will make as part of its equity contribution to the joint venture.

However, if the asset manager fails to meet certain performance

Typical real estate JV structure



Legend:

- Entities involved in the joint venture
- Agreements between entities in the joint venture
- Contractual relationships between entities in the joint venture
- Ownership of entities in the joint venture
- Capital investment into the joint venture entity
- M Mortgage
- S Share security

Abbreviations:

Luxco Luxemburg Company
Propco Property Company
ACP Alternative Capital Provider
AMA Asset Management Agreement
DoCA Duty of Care Agreement
FA Facility Agreement
PMA Property Management Agreement
SHA Shareholders Agreement
SPA Share Purchase Agreement
SPV Special Purpose Vehicle

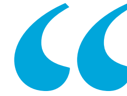
Source: White & Case

criteria under the AMA, the capital provider may have the right to terminate the AMA, and there will often be a series of key performance indicators to inform such a decision.

Governance matters

Knowing who is controlling the key levers in the JV is essential, as is understanding the different governance bodies. In a typical joint venture, the board would be in control. What is different in a real estate joint venture is that the third-party manager will have day-to-day responsibility for the decision-making relating to the property. Strategic oversight and investment decisions will be retained by the board (which is normally critical for the structure to deliver its intended tax result where the parties are international), with the decision-making powers on that board usually held by the investor. Money talks in circumstances of control and governance, and the investor will typically have nomination rights for the entirety—or at least, a majority—of the board. The manager's protection for certain key decisions will be through the list of reserved matters requiring unanimous shareholder approval.

If a JV is structured as a limited partnership fund, the decision-making role will be allocated to a general partner. In such instances, the general partner will effectively act as the



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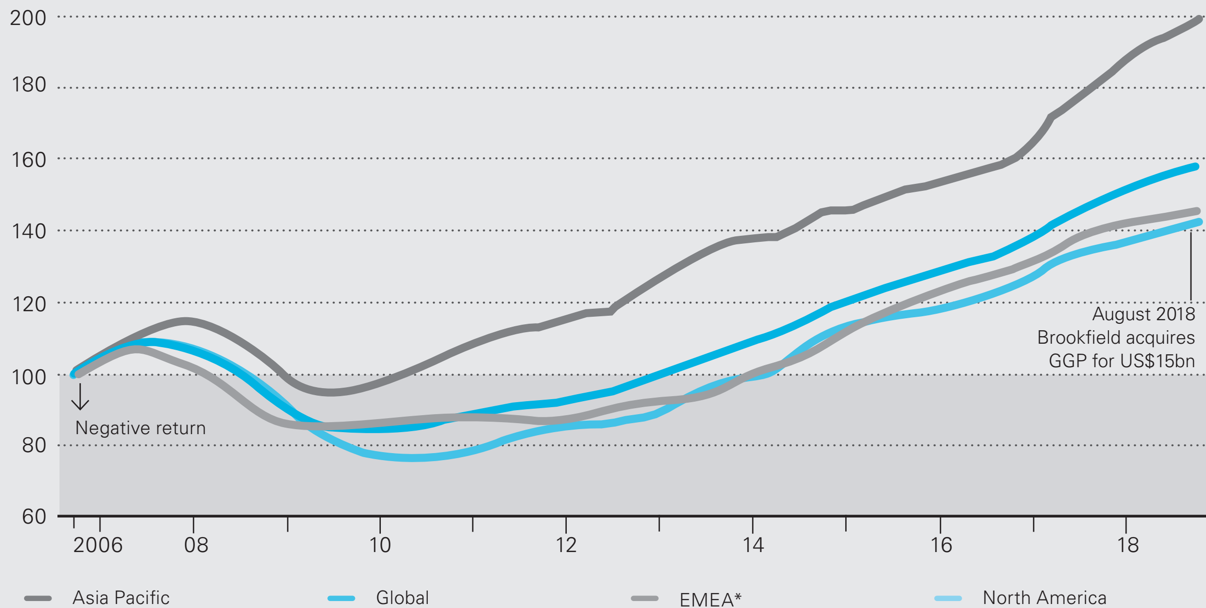
Global real estate prices reach new record highs

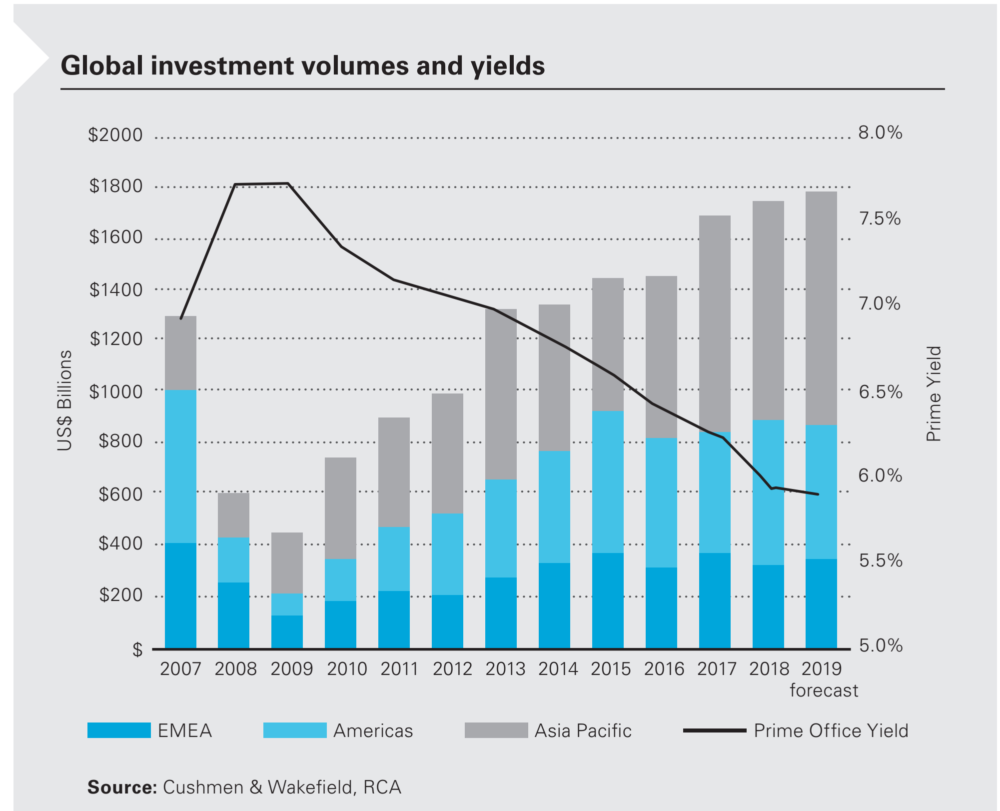
Cities composite (rebased Q4 2006 =100)



*Europe, Middle East and Africa. Based on independent reports of properties and portfolios valued at £2.5 million or more.

Source: Real Capital Analytics, The FT

Global investment volumes and yields



Source: Cushmen & Wakefield, RCA

board of directors of that fund, and it is important to understand what the different governance bodies are and take account of those accordingly.

Typically, every JV structure will have one or more key persons or Key Men—being key employees of the manager. This person or persons is often the main reason why the investor has paired up with that manager for that particular investment. The Key Man will be the most knowledgeable person within the fund manager and be key to the ongoing investment decisions of the investor.

There will be various provisions within the JV agreement that will cater for what happens if the Key Man ceases to be employed for whatever reason. Often they will relate to exit options for the investor and the rights to replace the key person with a specialist with similar experience.

Financing models

There has been an insurgence of alternative capital providers in the real estate finance market recently. Hedge funds, credit funds and even insurance companies are competing very strongly with the more traditional bank lenders.

There has also been a growing trend in mezzanine financing, which means that a real estate portfolio can be highly leveraged. Senior debt can be provided up to the 65 per cent loan-to-value level, and then mezzanine debt is injected in the case of a structural subordination further up the capital structure, with an increased risk profile.

In terms of security, it is typical for share security to be provided over the Propco that owns the assets. It is also common to see double Luxembourg-registered holding (Luxco) structures which sit above the property vehicle. This facilitates a company incorporated in Luxembourg (a creditor-friendly jurisdiction) over whose shares the lenders can take security.

Limited recourse security in real estate financing transactions is also common. In this scenario, lenders will only have recourse over the entity that has provided the security, i.e., if the SPV Luxco 1 vehicle has granted share security over its shares in SPV Luxco 2, the only recourse of the lenders is to those actual shares.

This is advantageous for both the investor and the JV structure because it means the SPV Luxco 1 can then own, for example, SPV Luxco 3 or SPV Luxco 4, which are completely separate and bankable real estate asset pools. The other advantage of a Luxco security—particularly in a multiple asset portfolio—is that it creates a single point of enforcement for the lenders.

Launch of IPSX—the first and only stock exchange dedicated to commercial real estate

Exit preparations

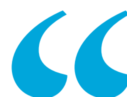
Exit planning should be front and centre in any real estate JV plan. Having a clear understanding of the exit strategy at the outset is fundamental. This goes to both the target audience, the target returns and also how the property is marketed.

Exit strategy will depend on the market environment at the time, but it must also be flexible to allow for differing market conditions.

One of the first considerations of the JV parties will be a lock-in. Often there will be no lock-in, leaving the investor free to exit,

Distribution waterfall

IRR	Shareholder distribution	Promote
0 – 8%	100% to shareholders pro rata	0%
8-15%	90% to shareholders pro rata	10%
Over 15%	80% to shareholders pro rata	20%



The asset manager's expertise, coupled with the investor's capital, allows both parties to maximise their respective returns and earn a greater share of the profits

but occasionally a lock-in period can be agreed for a fixed number of years during which there can be no exit. During a lock-in period, certain pre-agreed equity syndication by the investor and potentially the manager might be possible in order to de-risk the initial investments.

After the lock-in period, there are a number of exit mechanisms that the JV parties will be able to consider, and there is no one-size-fits-all solution. Propco or asset-level disposals is one option. 'Drag-along' at the JVCo level is another: when the lead investor is able to drag the minority shareholder—the manager—into an exit. The question would be whether there are any hurdles to the drag—be it through multiples or other valuation hurdles—that must be met for that drag to be exercisable.

In January 2019 the IPSX—the first and only stock exchange dedicated to commercial real estate—was launched in the UK, making an IPO a viable alternative for an exit for the joint venture partners. One of the benefits is that the issuers may also seek to take advantage of the UK REITs regime, granting them tax-efficient treatment of property rental income and capital gains.

In the event of a default, there will likely be a mandatory transfer event, forcing the manager to sell at discounted rates on the fair-market-value (FMV) of the stake.

In any circumstance, upon termination of the AMA, the investor will likely have a right to acquire the manager's equity to ensure that the equity and the manager are always linked and connected.

Target IRR

Last, but not least, is the target internal rate of return (IRR). There are different IRR expectations based on the type of investor, the asset class and the tenant profile. Higher IRRs are typically set for value-add portfolios and distressed portfolios, whereas for core or core+-based assets, lower IRRs apply.

An example of IRR-based distribution waterfall is set out above. In this instance, if an IRR is between 0 per cent and 8 per cent, the available profits are distributed 100 per cent to the shareholders on a pro rata basis. This includes the minority investment that the asset manager makes. No promote would be payable in such a scenario.

Similarly, if the IRR exceeds 8 per cent, then 90 per cent of available profits are distributed to shareholders, with a 10 per cent promote being available to the asset manager. Over 15 per cent of IRR means a 20 per cent promote, with consequent reductions in the shareholder distributions accordingly.

Payments of promotes on refinancings and staggered sell-downs are common. If sales haven't progressed as planned, or the exit strategy hasn't been followed, there may be a deemed distribution to cover the promote after a specified number of years.

There are instances when the promote may be 'switched off' if the AMA is terminated for cause, such as material breach of the joint venture agreement, failure to perform obligations under the asset management agreement or the asset manager's insolvency.

Real estate JVs: A win-win solution

A joint venture between a capital provider and an asset manager in a real estate transaction often offers greater benefits to both parties than a traditional investment. The asset manager's expertise is coupled with the investor's capital, which allows both parties to maximise their respective returns and earn a greater share of the profits. It's a win-win all around.

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