Let's Form a Joint Venture

By Joshua Stein PLLC

Construction lenders have become less exuberant. They won't lend as much as they did a year ago. Owners of development sites receive fewer unsolicited calls from brokers and developers than they did a year ago. And their sites are not as valuable as they were a year ago.

Given the reduced availability of financing and uncertainty on values, a developer who locates a desirable site might propose a transaction that does not involve acquiring the site outright. Instead, the developer might propose a joint venture with the property owner. The property owner contributes its development site, free of mortgage debt, to the joint venture. The developer probably funds some predevelopment costs from equity. Then the joint venture pays for the rest of the project through a construction loan secured by the property.

By avoiding site acquisition costs, a joint venture like this dramatically reduces the developer's capital requirements. Now the developer just needs to worry about construction financing, which should be easier to get without the need to also finance site acquisition.

The property owner benefits by receiving some share of the profits, a piece of the upside, assuming the project succeeds.

The transaction can work out well for everyone, especially the developer. But it also opens a rat's nest for the property owner, who might ultimately prefer a simple sale, even if it means the developer gets all the upside or the property owner will have to wait until the next real estate boom.

The risks of a joint venture start with the fundamental fact that if the project fails, the lender will likely foreclose, leaving the property owner with no property, no purchase price and no upside – a total loss.

So the property owner depends heavily on the developer's competence, credibility and creditworthiness. If the developer is a major REIT, the property owner will probably rely on its balance sheet and not worry. Newer or smaller developers probably can't deliver enough comfort. A medium-size developer might get there by delivering a letter of credit or cash deposit – either often a nonstarter.

The terms of these deals will vary. The property owner might see itself as "preferred equity," entitled to first claim on profits to recover the value of its non-cash investment. The developer might argue for an equivalent claim for its own cash investment. Whoever gets "first claim" may also expect "second claim" until they achieve a certain return on their investment. After that, the developer might have a greater claim to further profits. The sharing ratio could change as profits rise.

Any profits participation creates tremendous opportunities for whoever calculates and pays the profits. They will typically try to subtract as much as they can before measuring profits. So a careful property owner will try to keep a lid on those subtractions.

What happens if, because of the surprises that always occur in development, the project needs more money? The property owner will expect the developer to bear that risk. Similarly, the developer will sign guaranties to the construction lender. The property owner won't want any responsibility to the developer for any amounts the construction lender makes the developer pay on those guaranties.

If the developer does have to write unexpected checks, the developer will want to be repaid out of profits – maybe not the first profits, but some profits at some point. However that negotiation turns out, it means development risks will indirectly dilute the upside the property owner would otherwise have seen. The property owner will want to limit that dilution.

As another significant issue, every developer expects to get paid development (and other) fees during development, "to keep the lights on in the office," if the construction lender will tolerate it. But every dollar of fees paid to the developer comes ahead of the property owner's upside, and effectively reduces the developer's capital investment in the project. Property owners won't like that.

In addition to fees, developers also like flexibility. Things happen. Projects change. Pricing changes. Markets change. So any developer wants the ability to change the project and their strategy. If problems arise, they want the ability to replace the contractor or architect, reduce the quality of finishes or modify the construction loan. That's part of their expertise. Property owners often don't have that expertise – but they also want to know what they're getting into and not have it change too much. That's another business negotiation.

The property owner will also want to know that the developer will stay in the deal until completion or later, and may also care about who else is in the deal.

Though this article covers the big issues in joint ventures of this type, each issue is much more complicated than suggested here. Plenty of smaller issues will also arise. These transactions are not for the faint of heart.

Joshua Stein
Joshua Stein PLLC
501 Madison Avenue, Suite 402
New York, NY 10022
212-688-3300
joshua@joshuastein.com
www.joshuastein.com