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Insights

IMPROVING LIQUIDITY FOR ASIAN REAL ESTATE INVESTORS - PART 2

PARTIAL SELL-DOWNS AND REAL ESTATE JOINT VENTURES (PART 2 OF 2)

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SUMMARY

In this second article (in our three part series which explores joint venture and sale and leaseback arrangements for Asian real estate investors), we examine some of the key economic considerations that investors should bear in mind when considering selling down interests and forming a joint venture (JV) involving Asian real estate: (i) funding, (ii) distributions and waterfalls and (iii) exit mechanisms.

In case you missed it, the first article in the series 'Improving liquidity for Asian real estate investors - Part 1' where we discussed some of the other key JV considerations for Asian real estate investors (e.g. structure, governance and control, conflict of interests and deadlock) is available for you to read.

1. FUNDING

(A) QUANTUM

In Asia (as elsewhere), participants in real estate joint ventures need to agree on a range of issues in respect of funding of the JV including the amount of each participant's funding commitment, the timing and frequency of funding, the equity/debt ratio, the circumstances and mechanics for calling for additional funding and the consequences if a partner fails to fund. The required amount and stages of funding depend on the specific characteristics of the project or asset and the equity/debt ratio is driven by the financial capacity of each JV partner and tax considerations. The funding structure also has implications on voting and distribution rights and the priority of repayment.

(B) REGULATORY REQUIREMENTS

Once the funding provisions have been agreed commercially, the parties should check if there are any legal or regulatory requirements that need to be complied with. For example, in respect of a private limited JV company incorporated in Hong Kong or Singapore, there are filing requirements with the Companies Registry of Hong Kong or the Accounting and Corporate Regulatory Authority (ACRA) of Singapore (as applicable) in respect of the allotment of shares and requirements to update the Register of Members and the Significant Controllers Register of the company. Where a company listed on the Singapore Exchange (SGX) (or the subsidiary of such listed company) is a party to the JV, the listed company may be required to make public announcement and/or obtain shareholder approval (depending, for example, on the size of its total funding commitment relative to the size of the listed company). Similarly, if a company listed on Hong Kong Stock Exchange is involved in the formation of the JV, relevant approval and disclosure requirements in the listing rules may also apply.

(C) FUNDING DEFAULTS

When a partner fails to meet its committed funding obligations such failure to fund (if it remains unremedied) is likely to constitute an event of default, which may give rise to a right by the non-defaulting partner to terminate the JV. A non-defaulting partner may nonetheless wish to continue the venture (e.g. if the underlying assets or project is still being developed) and, if so, some useful remedies include: (i) the right to make up the funding shortfall by way of capital contribution to the JV, thereby diluting the defaulting partner's interest in the JV, (ii) the right to make a loan to the JV company in the amount of the funding shortfall at a certain enhanced interest rate, or (iii) the right to make such a loan to the defaulting partner (again, at a certain enhanced interest rate) which is immediately on-lent to the JV company to make up the shortfall. There may also be disenfranchisement of the defaulting partner, the stripping of its right to vote, right to appoint directors and right to distribution of dividends. The non-defaulting party may also be entitled to buy out the shares of the defaulting partner at a discounted rate.

(D) COST OVERRUNS

Correlated to the issue of funding is the question as to who bears the risk of a costs overrun (particularly for development projects). Will each of the JV partners be required to provide additional funding to the JV, or, will the project manager (or developer) be required to pay for this (for example, by withholding and setting off accrued management fees)? The JV partners naturally would prefer for the project manager to pay for any costs overrun (particularly if it is unrelated third party), so as to have greater certainty as to the partners' maximum commitment for funding and to incentivise the manager to work efficiently and stay within budget. On the other hand, the manager may only be agreeable to covering any overrun resulting from its negligence, misconduct or other material breach of management agreement.

2. DISTRIBUTIONS AND WATERFALLS

(A) PRIORITY OF DISTRIBUTIONS

Partners to a JV will obviously be very concerned about how any income or profit generated by the JV will be distributed amongst themselves and other stakeholders in the JV (such as third party financiers and managers). Debt (e.g. any senior or mezzanine debt) will generally be repaid first before any income or profits can be distributed amongst other JV participants. The priority of repayments is typically an inverse representation of the risks of the different forms of debt provided by different lenders (or other funding parties), that is, the higher priority the relevant lender has to receive repayment, the lower risk its investment entails (e.g. senior debt provided by a third party bank usually has the right to be repaid in priority to any debt owed to a mezzanine lender and any loans or equity contributed by shareholders).

(B) THE WATERFALL

Following the repayment of loans (e.g. any senior debt, mezzanine debt and shareholder debt), the profits of the JV will then flow to the JV partners (and if applicable, managers and any other stakeholders entitled to the distribution) and be distributed in an agreed sequence and manner, known as the "waterfall". Under a typical waterfall, the distributable amounts will first be distributed in a *pari passu* and *pro rata* manner in line with the equity ratio of the JV partners.

(C) PROMOTES

The parties may decide that once certain thresholds are reached, one (or more) of the parties (e.g. the operating partner or the party performing the manager role) may have an entitlement to the distributable profits which is disproportionate to their equity ratio. Such a disproportionate and additional share of distributions is commonly known as a "promote" in real estate transactions (whereas in private equity or investment funds transactions it may be referred to as "sweat equity" or "carried interest"). Promotes are often awarded as a recognition of the efforts of and input by the partner who manages the JV or project (such as in sourcing the opportunity, conducting due diligence, developing and managing the asset), and also as a tool to ensure that such partner, despite being the minority partner, is incentivised and has "skin in the game" to continue to look out for the best interests of the JV.

The pre-determined thresholds or hurdles triggering the payment of promotes are often tied to a specific internal rate of return (IRR), which measures the profitability of an investment by comparing the net present value of capital contributions (i.e. investor outflows) and the net present value of distributions (i.e. investor inflows). Crudely speaking, a higher IRR indicates a higher profitability and therefore, if a JV or project is expected to be more profitable, a higher IRR would be set as the threshold/hurdle for the payment of the promote to properly incentivise the manager or sponsor. In respect of real estate assets or portfolios, a value-add investment (being a property or portfolio which requires more capital expenses for refurbishment or repositioning, such as revitalisation projects in the Northern Metropolis of Hong Kong) is likely to have a higher IRR (but also higher investment risk) and thus a higher IRR hurdle in its waterfall than that of a core investment (being a property which is stable, has strong, creditworthy tenants and requires limited asset management, such as One George Street in Singapore, the Cityplaza office towers in Hong Kong or other large and fully leased office buildings in central business districts).

3. EXIT MECHANISMS

Some JVs have a fixed life span, such as following the expiry of a specified timeframe or on a specific milestone being reached. This is common in the real estate private equity transactions where an exit (e.g. through the sale of the assets or the holding company of the assets) is always front of mind. Alternatively, an exit may be achieved following the listing/IPO of the JV upon achieving specified targets (financial or otherwise). It is, of course, useful to be clear about the exit strategy in the JV documentation and specify exactly when and how the exit will be achieved (and what each party's roles and responsibilities are in achieving a successful exit).

However, joint ventures do not always go to plan and there may be early termination scenarios. For example, a JV may be terminated upon default, such as due to a failure to provide committed funding, a material breach of the JV agreement or by or the insolvency of a partner. A JV may also be terminated as a result of (i) a deadlock situation (as discussed in more details in Part 1 of this article), (ii) a change of control of a partner or (iii) under performance of the JV. No matter which scenario it is, the question remains who should get what upon such early termination. It is common in these situations for the value of the JV company to be determined by a third party accountant (or property valuation expert or surveyor, where the underlying asset is real estate) appointed by the parties (or a number of accountants or experts, with the price being the median or average of the valuations received). The JV documentation should specify the bases, principles and policies that are to be used in the determination of the valuation, such as whether any discount is to be applied on account of each JV partner's shares comprising only a part of the total share capital. In the case of termination by default, the non-defaulting party usually is entitled to apply a discount to the fair market value of the shares owned by the defaulting party when buying out such shares, or reversely, to apply a premium on its shares when putting those shares to the defaulting party.

Alternatively, a partner may unilaterally wish to exit by sale of its interest in the JV. Such sale would be subject to any transfer restrictions governing the JV, such as any pre-emptive right (the right for the existing partner(s) to purchase interest in the JV before such interest may be offered by the other partner to a third party) or tag-along right (the right for a minority partner to join in the sale in the case of a proposed sale to a third party by a majority partner).

CONCLUDING REMARKS

Selling down interests in a company (or other holding vehicle or structure) which owns real estate is an attractive way for investors in Asia to obtain liquidity and/or funding for other projects, particularly in difficult or unstable times. Investors should however tread very carefully and ensure that they establish appropriate parameters in the documentation so that they retain the level of control and economic return that they expect. JV partners should also think ahead and consider potential tensions and disputes that may arise, as well as, of course, how a successful exit will be achieved.

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