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# PERE Insights – tumultuous times but time to plan for growth? The utility of programmatic joint ventures for European real estate investment

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## 'It Is the Long History of Humankind (And Animal Kind, Too) That Those Who Learned To Collaborate and Improvise Most Effectively Have Prevailed' – *Charles Darwin*

Relationships and teamwork are crucial and now, more than ever, they are essential for real estate investors to navigate unchartered waters. Whilst the market is in flux, there are strategies which may be deployed to act as a springboard for growth, making it easier to put money to work when the time is right. One such strategy is the use of programmatic (or platform) joint ventures between a capital partner and operating partner to create a platform between the parties with settled terms and investment criteria ahead of downstream investments. Such platforms can harness and leverage an operating partner's network, facilitate a right of first look at certain deals for equity investors and promote speed of execution, thereby achieving a competitive advantage for the parties. Programmatic JVs continue to be attractive in the midst of the COVID crisis as many investors look to the future to secure their share of deal flow. There are, however, certain considerations to be borne in mind to ensure the partnership works successfully. This alert, the first of two on programmatic JVs, focuses on the key considerations for equity investors in respect of exclusivity and deal origination, non-compete provisions and alignment of interests on which we share some insights.

## 'We're More Than Friends, We're Family' – Exclusivity Arrangements

A critical element for the success of a platform JV is to ensure that the operating partner's expertise and connections are deployed for the benefit of the JV. The overriding objective should be to ensure that all deal opportunities meeting the agreed investment criteria are first offered to the capital partner. To achieve this, the exclusivity must bite not only on the operating partner but also on affiliates, employees, officers, agents, advisors and other representatives of the operating partner. The capital partner should also consider including a non-solicitation provision and non-circumvent language capturing all dealings and arrangements by the operating partner which might otherwise have the effect of sidestepping the investment purpose of the JV.

There is often a tension between the operating partner's desire to keep an eye on other business interests and the capital partner's desire to protect the value of the platform and, therefore, a debate as to how long the exclusivity period should last. A balanced approach may be one which weighs the need to protect the venture in its critical acquisition/aggregation phase against an acknowledgement of the operating partner's wider management business interests after a certain point in time. One tangible way to promote a longer exclusivity period is to pay acquisition fees on completion of successful deals, thereby promoting alignment.

## 'Family Comes First' – Non-Compete Restrictions

At their heart, non-compete provisions ensure, as far as possible, that the operating partner is focused on the portfolio within the platform as opposed to other competing assets. However, an operating partner may have other business interests and so one can expect lively debate around the extent of the non-compete period and geographical area to which it applies. Operating partners may resist a blanket restriction on participating in an asset, which satisfies the agreed investment criteria (regardless of location) but capital partners still fight hard to ensure that whatever the agreed restrictions are, they run for the entire investment term of the platform, or for an agreed period. In relation to the geographical extent of the non-compete provision, the parties may land on an agreed radius from target assets (that is, a restricted area in which the operating partner will not invest), but other objective criteria can also usefully be applied including asset size, rental value and tenant mix to name a few. Capital partners are often sympathetic that pre-existing investments and/or management mandates of the operating partner should continue in the ordinary course, notwithstanding that they might technically compete, so specific carve-out provisions are sometimes included. However, from the capital partner/venture perspective, it is important here to set out clearly how the operating partner should conduct any such permitted business and manage/notify specific conflicts between those carve-out assets and the portfolio.

## Investment Period and Deal Origination

*Right of First Offer ("ROFO")*

The above parameters set, the operating partner gets down to the business of aggregating a scalable portfolio and mining its own market relationships. Alongside the exclusivity and non-compete arrangements there will necessarily be an understanding that each and every qualifying opportunity falling within the agreed investment criteria, of which the operating partner becomes aware, will first be referred to the venture for approval: the ROFO process. This ROFO would commonly be extended to capture opportunities of which the operating partner's affiliates are also aware in order to mitigate the risk that an operating partner may attempt to circumvent the arrangement. Here again, it is important to ensure a harmony of interests and, thus, a general acknowledgement that the operating partner is not bound indefinitely and exhaustively to scour the market and originate deals for the venture alone. Commonly, therefore, practical compromises are reached. For example, ROFO obligations can often last for the duration of the relevant exclusivity period or otherwise until such time as the venture/capital partner has rejected, say, three consecutive qualifying opportunities: a 'three strike rule', so to speak. It is also not uncommon to allow an operating partner to pursue an opportunity if the venture rejects it following the investment approval process. However, the JV agreement should set out the terms on which the operating partner is free to transact in relation to that opportunity, i.e., ensuring subsequent deal terms are no more advantageous than those offered to the venture, limiting permitted deals to those that are outside the non-compete area, and, more importantly and prior to that point, ensuring that a clear and robust initial and final approval process is agreed and followed.

*Investment Approval Procedure*

That approval process is commonly a two-stage one. The preliminary process might cover key financial, target return and commercial information sufficient for the capital partner/venture to ascertain whether or not it should approve an initial investment memorandum and therefore proceed to due diligence and the acquisition phase. As part of the next phase, more granular due diligence is covered, including full cash flow underwriting and detailed legal and technical due diligence. These elements typically are featured in a form of final investment memorandum for approval by the capital partner/venture prior to completion (sometimes in a pre-agreed format). Operating partners will frequently try and retain as much flexibility and discretion on the process overall, the specifics of due diligence and thereby the content and form of any approval memorandum, the rationale being that they are best placed to determine what approach and associated materials suit the transaction in question. However, capital partners should ensure there is a sufficiently structured and formulaic approach as possible to ensure that key deal terms are achieved and deliverables are met for investment committee and other purposes. Capital partners will often have institutional standard requirements for final processes and associated memoranda and are wise to insist on certainty of deal terms in this regard and agree on any deviation on a case-by-case basis to ensure a satisfactory baseline across the platform.

## Alignment of Interests

*General Considerations*

The most fruitful partnerships are those which balance the intrinsic need for firstly, operating partner–capital partner alignment and, secondly, incentivisation for manager expertise and services. Focusing on the first element, it is important that the operating partner has meaningful funds of its own at risk ('skin in the game'). It will, of course, be a matter of negotiation on a deal-by-deal basis as to the appropriate level of minority capital investment, but it is becoming more and more commonplace to see representations and warranties in relation to operating partner capital, specifically, that it is and will at all times be sourced from the operating partner's own or its individual principals' resources and not from any third-party finance providers or managed funds. It is also interesting to see the convention from North American joint ventures beginning to pervade the European market in this respect, as those key individual principals are now often asked to join in the relevant covenants and give personal guarantees to cover breaches of the same operating partner failure to fund and other material manager defaults, aspects which we will cover in the next alert in this series.

*Funding Obligations and Consequences of Failure to Fund*

As to funding obligations themselves, it is advisable to set strict time frames on contributions and penalties following a failure to fund, to ensure that the operating partner's management and equity positions are affected adversely. How adversely affected will of course depend on the respective equity and bargaining positions and on the nature of the funding requested. For required/mandatory funding, expect to see an ability for the contributing partner to provide any funding shortfall at a preferred rate of interest and potentially that the operating partner loses any promote/carried interest – although this is an often hotly contested point for a failure to fund. It is also not uncommon to see a right for the contributing partner to convert shortfall funding (plus accrued interest) into equity on a dilutive (say, 2:1) basis. For optional funding, namely, funding requested on a discretionary basis outside the agreed parameters of the business plan/budget, failure to contribute will ordinarily not carry such penal consequences, so a lower rate of interest on shortfall funding with no equity conversion is common.

*Liquidity Alignment*

Alignment is also achieved through the overarching liquidity strategy of the platform and, in particular, the locking in of the parties during the investment phase of the venture. Unrestricted capital partner liquidity events are rare, and mutual lock-ins, for investment or other agreed minimum periods, are common in platform ventures. This initial collaborative approach encourages the parties to work together during the investment phase. By setting target milestones before which operating partners cannot exit, such as stabilisation of development projects, achieving AUM and NOI targets, the parties create alignment and optimise efficient management and operation.

It should not be forgotten that there is an imbalance of interests after a certain point in any venture. Capital partners may, justifiably, insist on controlling sales and an exit, but at the same time operating partners will be looking to realise their promote as early as possible. To meet both demands, the use of put and call options, exercisable before a full exit, are becoming more prevalent in platform JVs whereby the operating partner can put its interests on the capital partner prior to an exit to monetise some of its promote ahead of time. It has been intriguing to see deal terms such as this evolve throughout the market in recent years, now often featuring complex hypothetical valuation mechanics, provisions around retention of equity until full exit, and dealing with the exercise of these put and call rights on a project-by-project basis only, to name but a few.

## Closing Thoughts

The real estate investment landscape may be unsettled but savvy investors continue to look ahead, build strong and lasting relationships, and plan for the next phase in the cycle. Programmatic JVs are, unquestionably, one way to steal a march when deal flow returns. The next and final alert in this series will focus on what happens (in the hopefully unlikely event) where relationships break down and the specific contingencies to deal with that eventuality, to ensure that investors can future-proof for troubled times.