Equity Investment in Real Estate Development Projects: A Negotiating Guide for Investors and Developers

Meredith J. Kane

A good match between a developer and an equity investor requires a balancing of risk, return and investment horizon.

The financing of real estate development deals almost always involves at least two equity parties: the developer, who is also the active partner, and the equity investor or mezzanine lender. Together, the equity parties provide the 20 percent to 35 percent equity requirement sought by most construction lenders financing residential and commercial development projects today. Except in the case of development projects done by the best-capitalized developers, such as REITs or other institutional parties, nearly all development companies engaged in projects of substantial size seek equity partners on either a project-by-project or an ongoing relationship basis to provide somewhere between one half and all of the equity capital required for a project.

From the developer's perspective, the equity investment allows the developer to generate fees and returns based on his development skills and activities, rather than the investment of risk capital. It allows the developer to preserve capital to support guaranties made by the developer to lenders, and for use in a range of future fee-generating projects. From the equity investor's perspective, investment in a development deal allows the opportunity to generate leveraged returns in an optimistic environment at a level that is rarely available in real estate except in the case of riskier distressed or turnaround situations. From the financing bank's perspective, an additional level of comfort is created with a well-capitalized borrower backed by a deep pocket investor, which presumably has done substantial due diligence on the investment and can be expected to police the development process for the benefit of both equity investor and lender.

Equity Investors and Investment Objectives

A variety of funds and investors are available in the marketplace to pro-

Meredith J. Kane, Esq. is a partner in the real estate department at the New York City offices of the law firm of Paul, Weiss, Rifkind, Wharton & Garrison, a full-service international law firm.

vide equity to development projects. Different types of investors have different levels of risk tolerance, different threshold levels of return requirement, different time horizons for investment, and different tax considerations in structuring investments.

On one end of the spectrum are opportunity funds, which are prepared to take the highest levels of equity risk in return for a very high expected level of return. Current target returns for opportunity funds are currently in the low to mid-20s, based on time horizons to liquidation of no more than 3 to 4 years. On the other end of the spectrum are institutional endowments and pension investors, which are more conservative in asset class and in investment structure generally. These investors currently have return expectations in the low to mid-teens, based on holding periods of 7 to 10 years and deal parameters and structures that reflect a lower level of risk. In between are a range of other investors, including foreign investors seeking high returns, stability, and favorable tax treatment in U.S. markets, and private equity funds that may consist of either individual or institutional investors and may be narrowly or broadly focused in terms of asset class and investment objectives.

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The initial challenge for a developer seeking an equity investor is to choose a compatible partner from among the available alternatives. A compatible partner is one that has rate-of-return return hurdles that can be realistically met and time horizons that match those of the developer. While so-called patient or institutional money seems initially attractive for its relatively low return requirements and long time horizon, the relatively lower risk tolerance of these investors makes their money unusable or unavailable in many situations. Such situations may include those where a developer seeks to have a large portion of the equity requirement funded by the investor (e.g., 90 percent investor contribution to 10 percent developer contribution), or where a substantial portion of the developer contribution consists of contributed fees or appreciated land value rather than cash. Institutional money is also generally unavailable to fund pursuit costs, the riskiest capital required to fund predevelopment expenses before the project land and financing is assembled.

Options for Structuring the Investment

The critical economic concept in the structuring of an investment is to achieve the appropriate risk-adjusted return for the investor. The greater the overall risk of the investment, whether in terms of leveraged capital structure, timing of investment, security for investment, or otherwise, the greater the level of return required. As a legal matter, the equity investment can be structured as pure equity or as participating or mezzanine debt, depending on the tax situation of the investor and the overall capital structure of the project. But regardless of the legal structure chosen, investors consider as an economic matter that any investment in which the aggregate of mortgage debt and mezzanine loan/equity exceeds approximately 85 percent to 90 percent of the project cost carries the risks of equity, and should bear correspondingly higher equity returns.

Investors who do not have tax or statutory issues with direct real estate investment often favor a pure equity investment. Such an investment generally takes the form of a nonmanaging member or comanaging member interest in a limited liability company that owns the development project, with the developer partner as managing member.

Investors with tax considerations regarding unrelated business taxable income, and others with statutory or fiduciary restrictions against direct real estate investment, favor a mezzanine loan structure with participating interest. Such an investment is structured as a loan, generally to a bankruptcy-remote borrower that owns the development property or otherwise controls the entity that owns development property. The mezzanine loan is secured by a pledge of stock or membership interests in the entity that owns the development property, and generally includes a cash-management arrangement and a limited guaranty by the developer partner against bankruptcy or other interruption of cash flow to the mezzanine lender from the project.

A third form of investment requires no cash to be invested by the equity partner in the project at the outset. Instead, the equity investor issues a commitment for a “standby second,” or equity-level, takeout financing for the project, thereby allowing a construction lender to lend a higher loan-to-

value or loan-to-cost ratio than it would with a purely conventional take-out. If a conventional take-out would fund 75 percent loan-to-value on a completed stabilized basis, the standby second would commit to take out a portion in excess of the assumed 75 percent, thus permitting the construction lender to lend an equivalent additional amount during the development period. If the project has increased in value—the so-called development pop—at the time of stabilization and the actual available permanent financing is higher than the amount underwritten at the time of the construction loan, the standby second may never be called. Such a form of investment is cost-effective for the developer, because the standby money will typically receive only a few points at the time of commitment but a much larger number of points, plus debt service at a relatively high rate, in the event that it is actually funded.

Conditions to Equity Pay-In

Risk-averse equity money will generally commit to fund no sooner than the closing and funding of the project construction loan, i.e., only when all project land and other development rights have been secured; construction financing has been committed and all conditions to the closing of the construction financing have occurred; building permits, zoning, and other entitlements are in place; tax abatements have been granted; environmental reviews have been completed; and, in instances where a project is to be fully or partially preleased or presold, the applicable leasing and sale thresholds have been achieved. However, in order to get to this stage of readiness in a project a developer must fund considerable predevelopment expenses on his own, including deposits or option payments on land and development rights contracts, architectural fees for plans and legal fees for permits, entitlements, and project contracts. Where the equity investor's money is to be paid in at loan closing and is intended to reimburse funds expended by the developer in the predevelopment process, the developer must ensure that the construction lender will permit the refunding of the equity money to the developer.

Where a developer has more than one equity investor competing to fund a desirable, but speculative, deal, the willingness of an investor to share pursuit costs up to a maximum specified amount can be a positive factor in the developer's selection of the investor.

Cash Flow Splits and Developer Promotes

The key concern in structuring the cash flow and capital proceeds splits between the investor partner and the developer partner is to minimize the downside risk to the equity investor, while providing a substantial incentive to the developer partner for the deal to perform in excess of expectations. This is accomplished through progressive hurdle levels of cash flow and capital proceeds under which the investor receives a minimum target return before substantial cash flow is made available to the developer partner.

The use of leverage is a key factor in achieving the internal rates of return to the equity investor required to reach the hurdle levels at which the developer promotes are achieved.

A typical equity investment in today's market would distribute cash flow to each party on a pari passu basis based on invested capital, up to approximately 12 percent to 15 percent internal rate of return (IRR) on each party's investment. Above that initial 12 percent to 15 percent IRR threshold, the developer's "promote"—i.e., the share of cash flow distributed to the developer that is disproportionate to his actual cash investment—will likely increase by approximately 10 to 15 percentage points per hurdle. In a project in which the investor partner puts up 90 percent of the equity and the developer partner puts up 10 percent, typical splits might be 90 percent to the equity, 10 percent to the developer on a pari passu basis until the IRR of the parties equals 12 percent to 15 percent, then 80 percent to the investor and 20 percent to the developer pari passu until the investor has achieved a 15 percent to 20 percent IRR, with a final hurdle of 70-30 or 60-40 above an 18 percent to 20 percent IRR to the investor. A 50-50 split on a promote is usually achieved only where the developer party contributes a substantial share of equity capital or project returns reach extraordinary levels.

The use of leverage is a key factor in achieving the internal rates of return to the equity investor required to reach the hurdle levels at which the developer promotes are achieved. Where the basic

development yield of a project, calculated on a cash-on-cash or return on cost basis, may be approximately $10^1/_2$ or 11 percent, the leverage achieved from a 75 percent loan-to-cost construction loan with an $8^1/_2$ percent coupon can yield internal rates of return on equity investment in the 15 percent to 20 percent range.

Where the equity investment is structured as mezzanine debt rather than pure equity, the same economic splits between the parties can be accomplished through the establishment of fixed and contingent interest payments and principal amortization schedules. In contrast to equity, a true mezzanine loan will often contain a maximum interest rate, usually set at 35 percent or some other high threshold that is not expected to be exceeded.

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Development Fees

One of the ways that developers can achieve returns commensurate with their time, effort, and expertise involved in a project, even before hurdles and promotes are achieved, is through the use of fees for service. These include development fees, management and leasing fees, sale and marketing fees, construction supervision fees, project acquisition fees, and a myriad of other fees depending on the actual services rendered by the developer. The timing of the payment of these fees and the guaranteed versus contingent amounts of the fees are the major areas for negotiation among the equity investor, the construction lender, and the developer partner. Generally, most lenders and equity investors will permit bona fide fees, which represent the actual costs of overhead, personnel, and project supervision incurred by the developer in managing the project, to be paid to the developer party during the development period. Any fees that exceed the developer's costs in project administration—i.e., the profit portion of the fees—are generally paid only upon the meeting of certain performance hurdles, such as project completion, achievement of a certain percentage of sales or rentals, or achievement of a target average sales price or rental rate.

Operational Controls and Management Rights and Responsibilities

The area of investor oversight of project management and operations is one that can vary widely based on the level of sophistication, staffing, and nature of the equity investor. Nearly all equity investors, whether they structure their investments as pure equity or as mezzanine debt, will permit the developer partner to take charge of the basic development aspects of a project, including land assemblage, permitting, design, contracting, and marketing and leasing. In fact, many equity investors will not become involved in a project until following the completion of these activities.

However, when an equity investor becomes involved at the very inception of a project as, for example, in a situation where equity investment is identified as part of a bid or competitive offer on a project, the equity will normally demand consent rights over all of the basic planning and design aspects of the project. These include identity of the architect, identity of the construction manager, approval of plans and specifications, changes in plans and specifications, basic program including type and number of units, price points and rental and sales prices, identity of major tenants, and terms of major leases, other leasing parameters and terms of construction and permanent financing. The investor will generally agree that its consent will not unreasonably be withheld or will be deemed granted as long as the matter in question falls within parameters negotiated and defined in the agreement between the partners.

In addition to the project management matters just described, the consent of the equity partner is always required to specified "major decisions" of the entity, including the sale, lease, or refinancing of a project; the adoption of annual operating and capital budgets; the making of material changes in the development budget; the execution of major leases except in accordance with specified leasing guidelines; and any matters relating to tax treatment, accounting methods, bankruptcy, waivers of rights under contracts, or litigation.

Bank Loans and Guaranties

The construction lender will require certain guaranties from the borrower's principals, including a completion guaranty, a guaranty of nonrecourse carve-outs, an environmental indemnity, and in many instances a full or partial payment guaranty. In general, the equity investor looks to the developer partner to provide the personal guaranties to the construction lender, without resort to the credit of the equity investor. Where the developer makes these personal guaranties, the agreement between the developer and the equity investor typically provides for pro rata contribution by the equity investor to the developer partner for any guaranty payments that are called on to be made to the construction lender, except in circumstances where the guaranty payment arises because of misconduct by the developer or actions of the developer for which it is liable to the equity investor.

In some circumstances, particularly if the developer partner is not an entity of substantial net worth, the construction lender will seek loan guaranties directly from the equity investor. The issue of which entity will provide the guaranties, and what remedies and protections will be available to the equity investor in the event that the construction lender seeks the equity investor's credit to back the loan guaranties, is a matter to be addressed in the equity agreements and to be agreed on early in the negotiations with a construction lender.

The equity investor may itself seek completion and cost overrun guaranties from the developer partner. These guaranties can be funded through an obligation on the part of the developer partner to fund the first portion of a cost overrun, prior to any opportunity or obligation on the part of the equity investor to make additional capital contributions for cost overruns. Alternatively, the equity investor may have a specified limited additional capital contribution obligation for cost overruns, above which all overruns are to be funded by the developer. Bona fide additional development costs required to be funded by the developer are generally not treated punitively but are repaid from cash flow to the developer partner after the threshold internal rate of return to the equity investor has been achieved.

Exit Strategies

The time horizon of the equity investor and its exit strategy are among the most critical elements in structuring the equity investment. High yield "hot" money investors are looking for their return of and on invested capital within a period of 2 to 4 years. "Patient" money investors can have time horizons of 7 to 10 years prior to seeking an exit from the investment.

In any development project, maximum value is not achieved until the project is fully constructed and its operations stabilized, i.e., until the project is 90 percent to 95 percent leased and has been operating at pro forma economics for several consecutive months. On reaching stabilization, the project construction financing can be taken out with permanent financing based on stabilized net operating income and loan-to-value ratios reflective of stabilized operations.

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However, if the equity investor provided a large share of the initial project equity even permanent financing on a stabilized project at a market debt service coverage and loan-to-value ratio may not be sufficient to pay out the entire equity in the project. In such an instance, the developer partner may be forced to agree to put the project up for sale to take out the investor equity. For a number of developers whose objectives are to build and hold real property, this sale requirement can prove problematic.

While sale may be the most certain way for the equity investor to achieve its exit from the project, buy-sell and right-of-first-refusal provisions are protections that allow the equity investor to cash out at a perceived market value while allowing the developer partner the opportunity to bring in second mortgage financing, mezzanine debt, or additional lower-risk equity investment in order to cash out the equity and maintain ownership of the project. However, such a move dilutes the developer's returns in the project by forcing the developer to pay market value for a substantial share of the project equity. Ultimately, the equity investor's right to cash out of the project at fair market value on its time horizon is the most important aspect of the project to be negotiated between developer and equity investor. ■