GOING CO-GENERAL PARTNER

BY JENNIFER MORGAN AND R. DAVIS POWELL

As private equity funds and other institutional investors investing in real estate joint ventures continue seeking opportunities to increase return on investment and obtain higher yields, some traditional equity investors have partnered with sponsors in order to provide Co-GP capital. Investing through a Co-GP capital structure allows the equity investor an opportunity to generate higher returns, although subject to a different risk profile than a traditional real estate joint venture equity investment. This article will briefly describe a conventional Co-GP real estate joint venture investment structure together with business and legal considerations for the equity investor.

The traditional private equity real estate joint venture model is a marriage of convenience between two parties: (1) equity investors or limited partners (LPs) — investors with capital to invest in real estate projects who are resource constrained in identifying and acquiring it, and (2) sponsors (Sponsors) or general partners (GPs) — managers who possess expertise in acquiring and operating real estate in a particular market but are capital constrained. The LP typically contributes the vast majority of total equity (80%-95%), while the GP contributes the balance. When a joint venture makes a profit, both members typically receive pro rata distributions based upon their respective ownership percentages until the LP has achieved a specified return on its invested capital, and thereafter the GP receives an outsize share of the profits, called promote distributions. On very successful projects, the GP may receive promote distributions equal to 30%, 40% or even 50% of the profits above a certain hurdle rate, even though it originally invested only a small portion of the initial capital.

In order to participate in the GP's potential to generate outsized profits in a real estate joint venture, and also to invest capital not subject to the promote, some private equity funds or other traditional LP investors (Co-GPs) have formed upper-tier joint ventures with Sponsors to act as the GP in lower-tier project level joint ventures. These Co-GP investors often behave like traditional LPs with respect to investment approach and staffing, although their investments are not subject to the incentives paid to the GP and have the potential to earn a disproportionately high share of the profits. This article will focus on considerations for the Co-GP investor in a real estate joint venture platform.

PRODUCT TYPES

Co-GPs can invest in virtually any type of real estate asset that is suitable for an institutional real estate joint venture, although most Co-GP investors seek out opportunities to earn significant promote dollars through riskier investments. For example, Co-GPs often invest in development projects in secondary markets where the potential for promote distributions is higher.

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Many Co-GPs also invest in service oriented real estate platforms where the Co-GP participates both in the real estate investment and also in the management company. One possible structure involves the formation of two separate joint ventures between the Co-GP and the Sponsor. The first joint venture is the property company, whose subsidiaries function as the GPs in each project level joint venture. The second joint venture is the operating company, which is the service provider for each project. Certain asset classes, such as hotels, multi-family or senior living lend themselves to this type of Opco/Propco structure, where the Opco joint venture may become a valuable company independent of the real estate investments. Also, the Co-GP may participate in the fee income as well depending the structure of its co-investment into the service providers.

SPONSOR SELECTION

Sponsors are attracted to the Co-GP platform structure because it allows their limited resources to be stretched across significantly more deals. A Sponsor in a Co-GP structure may only contribute 1% of the total equity (or less) into each project level joint venture. The LPs in the lower-tier project level joint ventures are typically traditional LP equity investors, and may vary across the platform. These project level LPs are relying on the expertise of the Sponsor (and not the Co-GP) and desire for the Sponsor to have "skin in the game", however are generally willing to accept a lower equity commitment where the Sponsor's "Key Persons" are required to remain active in the business of the project level joint venture. From the perspective of the Co-GP, Key Person and similar restrictions in the project level management and operations limit the Co-GP's ability to remove the Sponsor as manager of the GP without consent from the project level LP. The financing documents may contain similar Key Person restrictions requiring lender consent for removal of the Sponsor's management rights as well.

Selection of a joint venture partner is always mission critical, although in a Co-GP structure, it may be even more important. Because the Co-GP and the Sponsor are partners themselves in the GP, the project level LP will exercise remedies against its GP (being the joint venture between the Co-GP and the Sponsor) in the event of a bad act or default by the Sponsor, so the Co-GP's invested capital is collateral for bad acts or defaults by the Sponsor. These liability and indemnity issues should be thoroughly analyzed at the outset, particularly in relation to the GP's liability under project level joint ventures and the circumstances under which the GP's promote may be subject to forfeit. It's worth reiterating that the Co-GP may be practically limited in exercising removal remedies against the Sponsor under the Propco without obtaining consent from the other counterparties in the structure, even where the Sponsor has committed a default. Once the Sponsor and Co-GP have built out a platform with multiple third party LPs investing in Propcos financed by different credit facilities, removing a Sponsor becomes quite messy.

SPONSOR FINANCING GUARANTY OBLIGATIONS

Co-GPs are not typically liable under any financing guaranties provided on behalf of project level joint ventures, whether for nonrecourse carveouts, environmental indemnities or completion guaranties. Sponsors strongly prefer to utilize the Opco and/or the Propco as the guarantors in lieu of obligating the Sponsor principals personally, if the lender will accept them. The Co-GP and the Sponsor should agree in the formation documents for the platform on the decision tree for determining the identity of the financing guarantors, together with any

indemnification obligations of the Opco, Propco or Co-GP in favor of the those guarantors. Co-GPs and Sponsors often discuss the allocation of liabilities under financing guaranties as part of the negotiations around the allocation of promote distributions between them.

DEAL SIZE

Because of the investment structure, a Co-GP will invest much less equity in each project when compared to a typical LP investment. Where the Co-GP has a limited number of investment professionals and corresponding limited bandwidth, it's important to partner with a Sponsor who is able to provide sufficient deal flow in order to invest enough capital into the platform so that it is worth the investment of human time.

EXCLUSIVITY

From the perspective of the Co-GP, the Sponsor should be exclusive to the Co-GP such that the Co-GP receives a first look at all potential investments in the pipeline. The Co-GP may be providing the Sponsor access to new lending and equity relationships for the project level joint ventures that the Co-GP desires to protect. If the Sponsor has competing priorities either from existing partners or invests for its own account, then the project selection rotation should be clearly defined for all parties. The Sponsor is concerned about granting exclusivity to the Co-GP and then having the Co-GP elect not to participate in investments that the Sponsor believes are worthwhile. Some investors address this by creating a "Three Strikes" structure, where if the Co-GP rejects three investments that meet the agreed upon investment parameters, then the Sponsor has the right to terminate the exclusivity relationship.

CONCLUSION

In summary, Co-GP investment structures can be a useful tool for traditional LP real estate investors to participate in the outsized profits available from promote distributions, although attention should be paid to selecting the right Sponsor partner and thinking through and documenting appropriate management and liability obligations within each level of the structure.

Jennifer Morgan (jmorgan@kslaw.com) and R. Davis Powell (dpowell@kslaw.com) are New York-based partners in the national real estate and private equity groups at King & Spalding.