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Adjusting Deals To Reflect Shifts In The CRE Market

By **Alexander Davis** (January 11, 2024, 6:13 PM EST)

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As most participants in the commercial real estate space know, the current stage of the real estate cycle — running roughly from mid-2022 to now — has presented the most challenging deal environment in the past decade.

The convergence of rapid inflation, the Federal Reserve's unprecedented federal funds rate increases, construction materials scarcity on the tail of the COVID-19 pandemic and low deal availability has curtailed the activity of even the most risk-tolerant real estate developers and investors.

Nevertheless, deals got done during this period, though in doing so, many developers and equity investors acquired properties and undertook development projects that they might have passed on during boom times.

This article explores some of the push and pull that has occurred in real estate joint venture negotiations during the current stage of the cycle and the ramifications resulting from them.

Power of the Purse

As a result of transactions being difficult to source, equity investors and developers needing to respectively deploy equity capital and obtain fee revenue, e.g. acquisition fees, development fees, etc., often increased their appetite for risk in order to continue undertaking new development projects in an environment of sparse potential projects.

In this stage, we observed sponsors — and by extension, their equity investors — closing acquisitions and joint ventures over issues that would normally be addressed prior to closing, essentially kicking the can on the issues to a later date.

This was usually accepted in the name of getting the deal done in order to put capital to work, in the case of equity investors, and keep the lights on, in the case of developers, who are often reliant on fee revenue.

During this stage, recognizing the dearth of equity capital available, many equity investors in development joint ventures are taking firmer stances on joint venture agreement provisions that, in the past, might have been more negotiable.

For example, during the boom times of the past decade, equity investors might have had softer terms concerning noncompete provisions that require the sponsor to bring new projects within a certain radius from the invested project to the equity investor — or might not have used these provisions at all.

Instead, within this stage, equity investors often insisted on an expansive radius but also that the sponsor would not be permitted to commence construction on competing projects until the invested project achieves completion or even stabilization.

In or Out

Despite the foregoing, and especially as the current stage, equity investors have not always come out ahead in negotiations during this period.

While there has been a dearth of debt and equity capital available during the current stage, as noted above, there have also been few deals on the market, whether as a result of sellers wanting to wait until the market strengthens before soliciting offers or as a result of developers not attempting to move projects forward.

Regardless of the particular reasons, the result has been that during the current stage, there have been fewer deals for equity investors to invest in, which has acted as a counterbalance to the power of the purse wielded by equity investors.

Understanding the power that developers wield when seeking equity capital for an appealing deal during a period of slow deal flow, many developers during the current stage have pushed harder in joint venture negotiations than they might otherwise have.

For example, developers have pressed — largely unsuccessfully — for greater ability to replace the equity investor, fearing that they could be stuck pre- or mid-project without a partner who is willing to fund.

This concern, while facially meritorious, reduces the equity investor's ability to ensure that its capital is being deployed without undue risk, as it will be hesitant to act in a way that would allow the developer to trigger its ability to replace the equity investor.

With private equity funds consistently focused on improving internal rate of return, the potential for equity to be returned to the fund without a meaningful return is a situation that should be structurally avoided.

During the current stage, equity investors have needed to, and must continue to, ensure that they are not recklessly agreeing to terms as a result of tunnel vision, which requires a level of discipline at the deal team level.

While deals may economically accept the view of an equity investor's investment committee, the overall level of risk in the deal may be much greater if certain noneconomic deal terms are agreed to or if certain unfavorable due diligence matters are accepted.

Lawyers on such transactions must take care to ensure that deal teams are not agreeing to matters, even those which are noneconomical, which exceed their authority.

If proper care is not taken, particularly during the current stage, while each risk may be individually small, the aggregate may result in substantial and unjustifiable risk.

Forward and Upward

As the commercial real estate market strengthens and moves out of the current stage, care must be taken when entering into new transactions with parties — whether it be lenders, equity investors, contractors or otherwise — with whom transactions were consummated during the current stage.

There is often a desire by parties to reuse so-called precedent transaction documents in an effort to minimize transaction costs and consummate transactions quickly, but as discussed above, terms may have been agreed to that would not have been agreed to in a market even marginally stronger than the current market.

Transaction parties will likely find themselves surprised and displeased if they reuse previous transaction documents without considering the particular issues that were conceded in the previous transactions.

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