

NOTHING VENTURED, NOTHING GAINED? THE RISE OF REAL ESTATE JOINT VENTURES

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Institutional real estate portfolios once consisted almost exclusively of stabilized, high-quality apartment, office, retail, and warehouse assets. Not so today, as the universe of institutional investments has broadened to encompass specialty property types like self-storage, senior housing, and medical office. It also spans development and acquisition of existing, unstabilized assets as institutions have embraced higher-risk/higher-return strategies. In the process, institutions have partnered with operating companies with track records in acquiring/developing and managing specialty property types and those with experience pursuing higher-risk strategies in the primary property types. Larger institutions have sought out operators to help execute core mandates, often buying into an operator's portfolio. This has been especially helpful in sectors like warehouse where investors have had difficulties assembling a portfolio through one-off acquisitions.

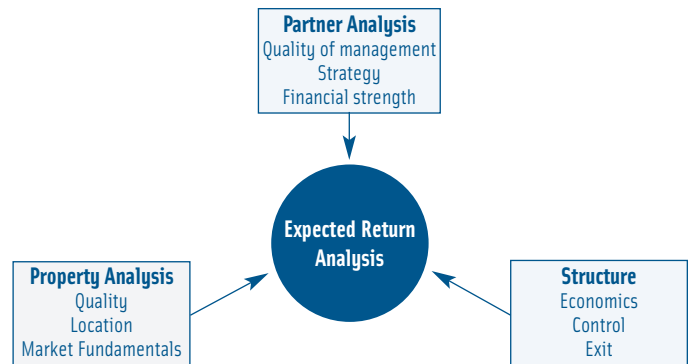
While relationships between operators and institutions have long been part of the real estate investment landscape, their sheer volume and their penetration into institutional real estate portfolios has increased substantially over the past fifteen years. Data from NCREIF provide an overview of the growth of joint ventures between institutions and operating companies and they help assess how such ventures have performed versus 100%-owned assets.

The first assets held in joint venture ownership were contributed to the NCREIF Property Index (NPI) in 1983, spanning seven office and five retail properties. By 1990, joint-venture-owned assets represented 4.6% of all NPI properties and 13.3% of the NPI on a market-value basis. The share of the property count represented by properties held in joint ventures grew to 11.5% as of 2000 when they represented 22.9% of the NPI market value. By first quarter of this year, joint ventures controlled 17.0% of all NPI properties, accounting for 27.8% of the NPI market value.

Receptivity on the part of public and private operators has facilitated the growth of joint ventures. The weak equity market of the late 1990s caused public real estate investment trusts (REITs) to seek alternative sources of capital. Close scrutiny by Wall Street of REIT debt levels precluded the funding of growth through a substantial increase in debt, propelling an array of REITs toward partnerships with institutional capital. Concurrently, private operators that had hoped to go public as a means of growth found that avenue blocked and turned toward the institutional investor as a capital supplier. Venture formation continued even after the equity market rebounded, with public and private REITs and other types of operating companies working to maintain diversity in their capital sources.

Based on the volume of joint venture investments made in recent years, one might conclude that they are easy to create and oversee. Nothing could be farther from the truth, as anyone who has put one together will attest. Joint venture creation and execution is a complex process, requiring focus, resources, experience and a lot of time.

Venture formation starts with the identification by an institution that such a relationship is the preferred means to execute a specific investment strategy. From there, three



separate sets of tasks must be accomplished. The chart above displays the three components of joint venture formation and execution.

The process typically begins with compilation of a list of prospective partners. Institutions generally seek a partner with demonstrated expertise in a property type or investment strategy. Such a company must possess sophisticated management and operating capabilities along with a well-formulated and well-defined business strategy. Optimally, such a partner will have past joint venture experience with institutions as this heightens the likelihood that the partner can satisfy institutional reporting requirements.

Due diligence on prospective partners entails scrutiny of their borrowing relationships, management tenure and track record. Each firm's capital structure is reviewed to determine capacity for growth. Management is evaluated relative to its experience in the venture's investment strategy, strategic plan, structure and stability. A firm's leasing and property management skills must be vetted as they will be essential to strategy execution.

Once a partner has been identified, a joint venture agreement must be negotiated. This document defines the economic benefits and obligations of each partner and the manner in which the partners will relate to each other throughout the venture. The intent of the agreement is to avoid conflicts between a for-profit operator and an institutional investor and to ensure that interests are aligned. Basic terms covered in this agreement include:

- | | |
|----------------------------|-------------------------------|
| Level of equity investment | Sharing of profits and losses |
| Leverage | Control and governance |
| Residual sharing | Exit strategy |

As the joint venture agreement is being negotiated, the strategic plan for the venture is being finalized. For a strategy involving contribution of assets held by the partner into the venture, this analysis includes an assessment of the underlying value of the property(ies). As part of this, the physical aspects of the asset(s) are critiqued, including construction quality, design functionality, tenant credit, capital expenditure history and projected capital needs. A full market analysis should be conducted, gauging tenant demand for the asset(s), its competitive advantages and disadvantages in its submar-

ket, prospects for that submarket from a tenant-demand perspective, and the risk of future competition.

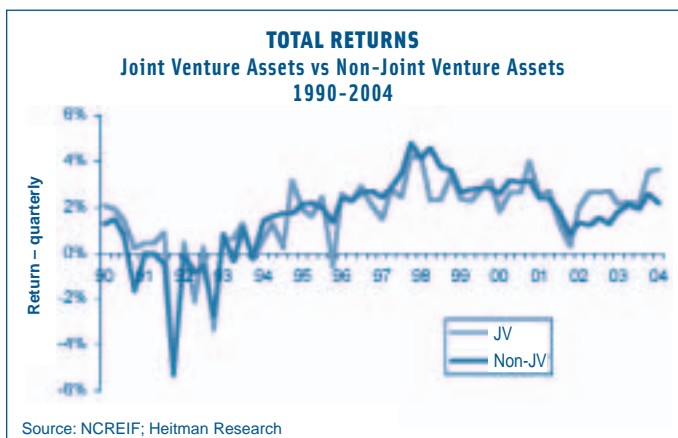
For ventures involving acquisitions, the strategy must get articulated, including a statement of what types of properties are to be acquired, at what price, and what expected return. What is the business plan for the properties? If this is a value-added strategy, how is value being added and at what cost? Target markets are a common feature of venture strategies. Will the venture have exclusivity in these markets? If the venture involves development, responsibilities must be established. Who pays for cost overruns? When will the asset being developed be contributed to the venture and are there hurdles it must meet before it is eligible (e.g., leasing targets or NOI thresholds)? What if construction delays occur?

Assuming the relationship survives the creation of the joint venture agreement and the critique of the investment strategy, it moves into the implementation phase. During this period, the venture must be monitored to ensure the strategy is being executed as conceived. This includes scrutinizing venture costs to ensure they are being allocated appropriately, examining budgets, comparing budgeted performance to actual on a monthly or quarterly basis, reviewing weekly leasing activity reports to determine the effectiveness of the leasing team. Finally, while joint ventures typically include a lock-out period, during which neither party can trigger a sale, a hold/sell analysis must be conducted once that lock-out period is concluded.

Institutions typically enter joint ventures on the expectation that their performance will exceed that of assets owned 100%. They base this on several factors. These include the operating expertise of their joint venture partners, the access such partners provide to high-quality assets, on the leasing leverage such firms often command, and on their ability to run properties efficiently during all parts of a market cycle. So how have joint venture properties done?

The chart below shows returns for assets held in joint ventures versus 100%-owned properties since 1990. During this period, joint venture properties performed slightly better than did the non-joint venture properties, achieving a total quarterly return of 1.67% versus 1.64%. It also looks as if they performed better during periods of property market weakness, outperforming in the early 1990s and again since 2001.

When performance is analyzed by property type, joint venture properties generally outperformed and the margin of outperformance was greater than was evident when the property types are aggregated. For three of the four property types where full-period results were available, joint venture assets outperformed by margins ranging from 9 basis points in the



PERFORMANCE COMPARISON
Joint Venture Assets vs Non-Joint Venture Assets
1990-2004

	Full Period		1998-2004	
	Non-JV	JV	Non-JV	JV
Apartment	2.26%	2.06%	2.63%	2.90%
Hotel	N/A*	N/A*	1.95%	1.87%
Industrial	1.87%	2.45%	2.66%	2.51%
Office	1.30%	1.52%	2.41%	2.44%
Retail	1.69%	1.78%	2.69%	2.87%
Total	1.64%	1.67%	2.52%	2.59%

Outperformance shown in bold

** The first hotel joint venture asset was contributed in 4th quarter 1997*

Source: NCREIF; Heitman Research

retail sector to 58 basis points for industrial. Joint-venture-owned apartment assets represent the exception – they underperformed apartment assets owned 100% by 20 basis points.

Joint ventures have evolved over the past 15 years. Among other flaws, many early joint ventures involved minimal equity contribution by operating partners. When the market cycle turned down in the early 1990s, and equity shares were wiped out for venture partners, their attentiveness to properties owned in these joint ventures tended to slip. As a result, these properties often underperformed. Because of this, we looked at recent performance, starting in 1998 as the share of joint venture properties in the NPI began to accelerate rapidly. The results are presented above. They show joint venture assets outperformed in total, with quarterly returns averaging seven basis points over those for non-joint venture assets. Further, for three of the five property types, joint venture assets outperformed modestly. This outperformance was greatest for apartments (27 basis points) and retail (18 basis points).

While some degree of outperformance exists for joint venture assets during both the full period since 1990 and since 1998, the results are not conclusive. Two possible reasons come immediately to mind. First, joint ventures are a common method by which institutions invest in development and redevelopment strategies. Given NCREIF property contribution requirements, performance data on development or redevelopment properties would get included in the NPI when an asset attained 60% occupancy. During the lease-up period for these assets, they would underperform stabilized assets. Further research is needed to assess the impact of investment strategy on performance.

The second explanation relates to size of assets. Assets held in joint ventures tend to be large. Their average size as of 1990 was \$57.7 million versus an average for non-joint venture properties of \$18.1 million. That pattern has continued, with joint venture asset size averaging \$57.5 million as of 2004 versus \$29.6 million for the non-joint venture properties. This difference in asset size would contribute to outperformance if these larger assets were doing well and underperformance if they were not.

To conclude, initial results show modest outperformance by assets held in partnership between institutions and operating companies versus those owned outright. Further research is warranted to explore the reasons for the outperformance and to isolate factors that, if controlled for, could reveal greater performance differences.