



**JVs changing the
US real estate
market**



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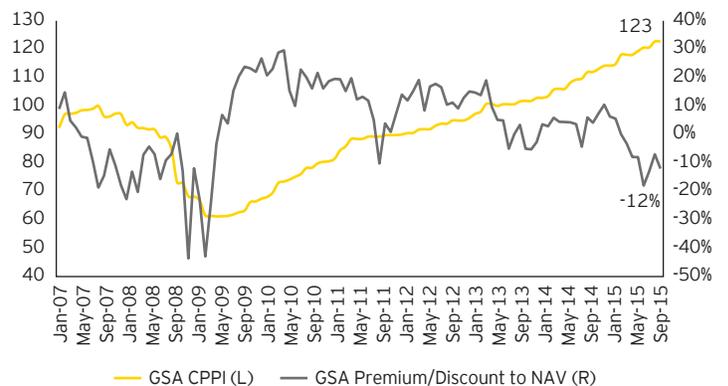
Commercial real estate is a high-value, capital-intensive industry that lends itself to joint ventures (JV) and partnering. Over the past year, more US real estate investment trusts (REITs) and US C corporations (corporations) have turned to JVs to raise capital for a variety of purposes. Furthermore, as President Obama and the US Congress have enacted tax-law changes that affect tax-free treatment of certain spin-off distributions, corporations with a large concentration of owned real estate previously considering a spin-off might turn to JVs as an alternative. We expect JVs to figure prominently into capital allocation decision-making in 2016. With no such thing as a typical JV structure, transactions can be tailored to the needs of each party. As Mike Straneva, US National Director of Transaction Real Estate, highlights, "The beauty of the partnership/LLC vehicle is its flexibility. But JVs require careful due diligence, tax structuring and corporate governance features so that the joint ventures have their best chance for success."

REITs

Recent market conditions have made raising capital more difficult for REITs. As Figure 1 shows, commercial real estate prices have risen, yet many REITs have traded at a discount

to net asset value (NAV) since May 2015. Depressed share prices make raising equity dilutive to existing shareholders, while issuing debt may negatively impact leverage ratios. Although debt markets remain accommodating, increasing leverage ratios may not be ideal as we move toward the later stages of the current cycle.

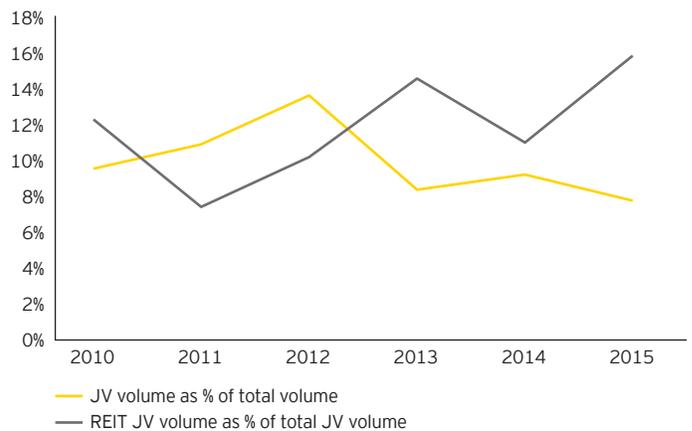
Figure 1: Green Street Advisors Commercial Property Price Index vs. premium/discount to NAV Jan 07-Dec 15



Green Street Advisors Commercial Property Price Index is indexed to 100 in August 2007.



Figure 2: US REITs are increasing their share of JV transaction volume



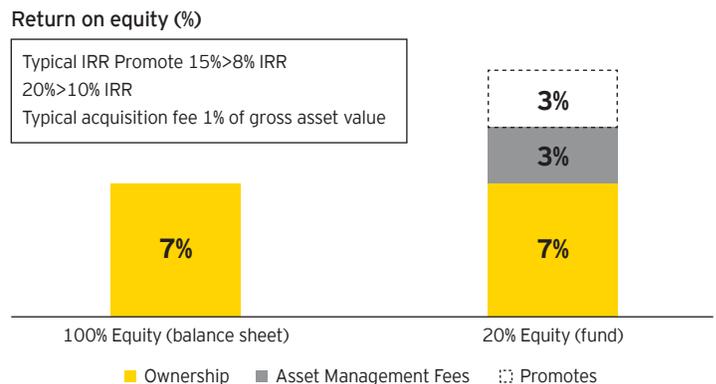
Source: Real Capital Analytics

Partial interest dispositions of specific assets to JVs may be a viable option for REITs that need to recycle or raise capital. They also have the added benefit of helping validate NAV estimates. One downside of divesting assets is the loss of net operating income (NOI) or funds from operations, but well-structured transactions where the seller retains management rights and incentive fees can help mitigate the impact to some degree.

More REITs have turned to JVs recently. In fact, the dollar volume of REIT JVs increased 50% in 2015 vs. 2014.¹ We believe that existing market conditions are such that JV volumes will increase further into 2016. On the buy-side, institutional investors are still looking to deploy capital and are open to JV structures. JVs remain highly flexible and allow institutional investors to provide capital in exchange for attractive returns, while the REIT, as the typical managing partner, provides operating know-how and experience with managing well-established assets in return for a promote. Figure 2 demonstrates that while JVs have comprised a smaller portion of overall transactions since 2012, REITs have made up more of the overall JV volume during the same period.

As figure 3 shows, JVs can be accretive to REIT and corporate earnings before interest, taxes, depreciation and amortization by offering management fees and potentially promotes over and above certain hurdles. They can, however, create complexity for the parties involved. Potential partners in a JV need to undertake a full strategic review of the pros and cons of the specific JV arrangement, including tax structure, governance and valuation considerations.

Figure 3: From an operator's (REIT) perspective, JV or fund structures potentially enhance returns



Source: EY

1. Real Capital Analytics

“Longer-term capital providers, such as insurance companies, pension funds and sovereign wealth funds, have been particularly interested in JVs.”

As we move through 2016, we see three primary uses of JV proceeds:

To support ongoing operations, including paying down or retiring debt, funding future acquisitions or funding the development pipeline.

To gain flexibility for REIT management teams' capital allocation – on both sides of the balance sheet – is a priority. A strong balance sheet provides management with the flexibility to take advantage of opportunities as they present themselves. To do this, management needs to be flexible in deciding which levers to pull at different points in the cycle. Selling non-core assets is an obvious priority, but off-loading core assets is a much less attractive proposition and may be to the detriment of management and shareholders' long-term interests. JVs potentially provide a solution to this. As Boston Properties highlighted in its 2014 JV portfolio deal with Norges, the JV transaction allowed Boston Properties to retain cash flows from highly desirable properties while at the same time monetizing part of the company's portfolio and returning capital to investors via a special dividend. The proceeds were also used to help fund new development projects. The deal allowed the REIT to maintain a presence in important markets and grow its relationship with an important and deep-pocketed institutional investor.² In some cases, REITs also have the option to buy out the JV partner at a later date.

To arbitrage the public-private differential by repurchasing shares or issuing special dividends. With many REIT shares trading at a discount to NAV, selling assets or partial stakes in order to repurchase shares may be accretive to existing investors. In 2015, Macerich announced that it would use a portion of the proceeds from a JV sale to buy back shares while using the remainder to issue a special dividend to shareholders.

What kinds of institutional investors might be interested in utilizing JVs?

Longer-term capital providers, such as insurance companies, pension funds and sovereign wealth funds, have in recent years been particularly interested in JVs. These investors enjoy a low-cost or highly stable source of capital, and the



2. "Boston Properties Agrees to Sell a 45% Interest in Each of 601 Lexington Avenue, Atlantic Wharf Office Building and 100 Federal Street," Boston Properties, 16 September 2014; "Boston Properties Declares Special Cash Dividend of \$4.50 Per Share and Regular Quarterly Dividends," Boston Properties, 8 December 2014.

“Overseas investors tend to be particularly open to JV structures as a way to gain attractive returns while minimizing management requirements.”

opportunity to purchase high-quality or tightly held assets, such as regional malls or coastal gateway office properties, remains appealing. REITs might be prepared to sell down stakes in prime assets to these institutional investors to fund their business plans, while still retaining interests in their core assets.

Other owners of real estate will likely find value in JV deals. A 2016 deal involved MetLife Investment Management (MIM) forming a JV with pension fund New York State Retirement Fund. MIM sold a 49.9% stake in a seven-building office portfolio to the pension fund for \$1.4 billion. Besides retaining a controlling interest in the portfolio, MIM agreed to manage the properties.³

Domestic investors remain the most important capital source in the US real estate market, but overseas investors, who deployed a record \$93b into US real estate in 2015, should continue to be considered as potential partners. Overseas investors tend to be particularly open to JV structures as a way to gain attractive returns while minimizing management requirements. Also, foreign pension funds are benefiting from a recent US tax law change in the Foreign Investment in Real Property Tax Act (FIRPTA) rules that enables them to invest in US real estate and JVs without a US tax cost upon their exit from these investments.

Restriction on certain tax-free spin-offs – the rules have changed!

As mentioned above, recently enacted tax legislation will affect certain tax-free spin-off distributions. The complex new rules provide, for example, that the spin-off of a REIT will generally no longer be tax-free to the corporation and its shareholders. The rules also provide that a corporation that has been distributed in a tax-free spin-off will not be able to elect REIT status for 10 years after the spin-off. Some options will remain possible; conversion of entire entities to REIT status will be possible, as will taxable spin-offs of REITs. Finally, REITs can still spin off existing REITs and certain corporate “taxable REIT subsidiary” entities.



3. Meghan Morris, “MetLife forms JV with NY Common,” PERE, 20 January 2016.

“ JVs offer many of the same benefits of tax-free spin-offs, such as releasing equity to be deployed elsewhere.”

Evaluating the implications associated with utilizing a JV structure is likely worthwhile for real-estate-heavy corporations that can no longer avail themselves of tax laws that allow tax-free spin-offs. JVs offer many of the same benefits of tax-free spin-offs, such as releasing equity to be deployed elsewhere. They allow corporations to streamline real estate portfolios and reduce exposure to specific markets or disproportionately large assets. JVs may also reduce the actual or perceived competition for capital resources within an organization. They also provide an opportunity to unlock shareholder value by creating a residual public company with more distinct investment characteristics. A transaction can also help validate the worth of real estate that is not necessarily recognized.

But there are significant challenges of utilizing JV structures for both vendors and investors. Counterparty risk is a particular issue, especially if the seller occupies

all the space. Alignment of interests is also important, particularly if the transaction is structured as a partial sale and leaseback transaction. In such cases, it is important that the lease structure provides flexibility in NOI growth to warrant investment in the portfolio from both parties. JV arrangements can deteriorate rapidly if one partner experiences financial distress, if the partners' interests diverge, or if the going-in valuation or operating terms of the JV turn out to be good for one party and unfavorable for the other.

Buoyant US real estate markets, with \$533b transacted in 2015,⁴ should allow vendors to extract a full price for high-quality portfolios. Finding the right JV partner, and not just the highest bid, still remains critical. Tenants – for example, corporations participating in leaseback transactions – that continue to occupy the space ideally want long-term alignment from a partner. This likely favors insurance and pension funds, potentially sovereign wealth funds, and

4. Real Capital Analytics



“The flexibility provided by a well-structured JV remains an important capital allocation tool and a means to create shareholder value for both REITs and corporations.”

possibly REITs and private-equity investors targeting core-type returns. An additional benefit may come in aligning to those with operational expertise and the ability to deliver property expansion and/or development plans across the portfolio. For large portfolios or blue-chip corporations, extracting full value from a transaction while also aligning to an appropriate partner requires a full and extensive marketing process. Utilizing relationships and conversations remains an essential component of finding the right JV partner.

2016 will likely be an active year for real estate JV transactions in the US. Market conditions are such that REITs and corporations are likely to be willing contributors of assets. The flexibility provided by a well-structured JV remains an important capital allocation tool and a welcome

means to create shareholder value for both REITs and corporations. At present, there is no shortage of interest in quality portfolios from both domestic and international institutional real estate buyers. The number of potential JV partners has likely never been higher. Careful due diligence, tax structuring and corporate governance are required for a JV to have the best chance for success. Aligning with a like-minded and trustworthy partner around a suitable structure and a clear strategy remain essential requirements for long-term success.



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EYG no. DF0236

BMC Agency
GA 0000_05377

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