What is a Joint Venture?

A joint venture (or JV) is "a business arrangement in which two or more parties agree to combine their resources in order to accomplish a specific task."[1] In this article, I will discuss how a JV can be beneficial to a property owner in today's commercial real estate market. In particular, I discuss how a JV may lead to significantly more value (both on a pre-tax and after-tax basis) than an outright sale.

A JV's structure can range greatly from simple to complex, and have many details pertaining to the initial capital invested, responsibilities of each party, and financial obligations of each party. In addition, there can be many intricacies around equity splits and distributions. Below, I will review a simplified, yet a real example, that our SVN Self-Storage Team recently completed to portray the fundamental dynamics and benefits of a JV.

Why A JV May Be Financially Beneficial

First, we should note a foundational principle of real estate development. As real estate moves along the development pipeline – value is created. Many of us are aware that entitlements have become more difficult to obtain, construction costs have fluctuated, and leasing a self-storage facility takes time. All of these stages have some inherent risk. Thus, as these hurdles are overcome, pools of developers and buyers are willing to pay a premium for the reduction in risk.

This concept provides land owners an opportunity to team with an experienced self-storage developer and create a JV for a development project. As the site is developed, the land owner participates in the value creation. In turn, they are also participating in some additional risk.

How a JV Works - Recent Case Study

The SVN Self-Storage Realty Team recently completed a JV deal in Rockland County, NY. The proposed project is to build a two-story, 100,000 Gross Square Foot, self-storage facility.

Our client (and property owner) is a savvy commercial real estate professional, but had never developed a self-storage facility. Going into the process, we were told he preferred not to sell the site. However, he was hesitant to enter a new industry, and did not want to take on a large construction project (or loan) without an experienced partner.

As a next step, the property was analyzed and underwritten by my SVN colleague and me to establish a value. The property was worth $5 million, but the owners still had $2 million left on the loan balance. Thus, ownership had $3 million in equity to contribute into a joint venture.

Our task was to attract experienced self-storage developers, willing to contribute capital, assist with the approval processes, oversee the construction, provide industry guidance, and engage a third-party manager. We successfully solicited multiple JV offers and eventually guided the owner when choosing a bidder. The fact remains that a JV is a business relationship. In this example, the ownership not only felt comfortable with the selected developer's experience, but also with their business philosophy, long-term outlook, credit worthiness, and personality fit. All played a role in the selection process.

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[1] https://bit.ly/2MY75OR

Now, let's discuss the financial benefits of this deal.

The Numbers

For ease, I will round the total projected construction costs to $7.5 million. With the property value added ($5.0 million) we have a $12.5 million total investment. The new JV will leverage at a 60% loan to value ratio. This equates to $5.0 million in equity needed for the $7.5 million loan.

As you will recall, the property owner had $3 Million of equity in the property to contribute into the deal, the developer (JV Partner) contributes the additional $2 Million of capital necessary. Looking at the capital contributions alone, this would be a 60/40 split for the new JV's ownership.

However, the developer (or JV partner) is doing more than providing $2 million in capital. The developer is providing the industry expertise, devoting personnel time, and guaranteeing the loan. In exchange for this work and risk, the developer has been given a 5% increase in equity, or a total of 45% equity in the deal. Let's assume there is no developer promote (performance bonuses) or other developer fees earned in this example. This is how the numbers work out for the property owner.

The project's proforma (financial projections) shows a net operating income in year five of $1,225,000. Assuming an exit cap rate of 7%, this property has a projected stabilized value of $17,500,000. There is a loan to pay off, which is $7.5 Million +/-, leaving $10,000,000 to be split between the JV parties at the time of sale. 55% to the original owner is now worth $5.5 Million.

All in all, the owner went from $3 Million to $5.5 Million over five years, and this does not include any net income splits or any possible tax shelters.

Learn More

To learn more about JVs, developing a self-storage facility, brokerage, the SVN Self-Storage Reality Team, or any of our consulting services, please feel free to contact me.

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