Strafford

Presenting a live 90-minute webinar with interactive Q&A

Structuring Equity Joint Ventures for Hotel Acquisitions and Development

Navigating Preferred Return/Promoted Interest, Carried Interest, Cash Flow Splits, Risk Allocations, Guarantees and Key Issues

THURSDAY, FEBRUARY 18, 2016

1pm Eastern | 12pm Central | 11am Mountain | 10am Pacific

Today's faculty features:

Jonathan Falik, Founder and CEO, **JF Capital Advisors**, New York

Tara K. Gorman, Shareholder, **Greenberg Traurig**, Washington, D.C.

Guy Maisnik, Partner, **Jeffer Mangels Butler & Mitchell**, Los Angeles

The audio portion of the conference may be accessed via the telephone or by using your computer's speakers. Please refer to the instructions emailed to registrants for additional information. If you have any questions, please contact **Customer Service at 1-800-926-7926 ext. 10**.

Tips for Optimal Quality

FOR LIVE EVENT ONLY

Sound Quality

If you are listening via your computer speakers, please note that the quality of your sound will vary depending on the speed and quality of your internet connection.

If the sound quality is not satisfactory, you may listen via the phone: dial **1-866-927-5568** and enter your PIN when prompted. Otherwise, please **send us a chat** or e-mail **sound@straffordpub.com** immediately so we can address the problem.

If you dialed in and have any difficulties during the call, press *0 for assistance.

Viewing Quality

To maximize your screen, press the F11 key on your keyboard. To exit full screen, press the F11 key again.

Continuing Education Credits

FOR LIVE EVENT ONLY

In order for us to process your continuing education credit, you must confirm your participation in this webinar by completing and submitting the Attendance Affirmation/Evaluation after the webinar.

A link to the Attendance Affirmation/Evaluation will be in the thank you email that you will receive immediately following the program.

For additional information about continuing education, call us at 1-800-926-7926 ext. 35.

Program Materials

FOR LIVE EVENT ONLY

If you have not printed the conference materials for this program, please complete the following steps:

- Click on the ^ symbol next to “Conference Materials” in the middle of the left-hand column on your screen.
- Click on the tab labeled “Handouts” that appears, and there you will see a PDF of the slides for today's program.
- Double click on the PDF and a separate page will open.
- Print the slides by clicking on the printer icon.

STRUCTURING EQUITY JOINT VENTURES FOR HOTEL ACQUISITIONS AND DEVELOPMENT

February 18, 2016 Webinar

Jonathan Falik

JF Capital Advisors

(917) 238-6917
jonathan@jfcap.com

31 Union Square West
New York, NY 10003

Tara K. Gorman

Greenberg Traurig LLP

(202) 530-8519
gormant@gtlaw.com

2101 L Street, N.W. Suite 1000
Washington, DC 20037

Guy Maisnik

Jeffer Mangels Butler & Mitchell LLP

(310) 201-3588
mgm@jmbm.com

1900 Avenue of the Stars, 7th Floor
Los Angeles, CA 90067

Jonathan Falik
Founder & CEO
JF Capital Advisors

Jonathan Falik is the Founder and Chief Executive Officer of JF Capital Advisors. Jonathan leads the firm's hospitality business, which includes equity and debt placement, asset acquisitions and dispositions, portfolio transactions, JV structuring, asset management, management company and brand evaluation, and strategic and capital markets advisory services.

Jonathan was a Senior Managing Director and the Head of Hospitality Capital Markets at BGC Real Estate Capital Markets. Simultaneously, Jonathan was the Head of Hotel Investment Sales for Newmark Grubb Knight Frank. Previously, Jonathan was a Managing Director and Head of the Lodging and Leisure Investment Banking group at Cantor Fitzgerald & Co.

Prior to joining Cantor Fitzgerald, Jonathan was the founder and CEO of JF Capital Advisors, a lodging advisory and principal investment firm. While at JF Capital, Jonathan led the acquisition and development of 25 hotels with over 5,500 keys at an aggregate cost of approximately $1 billion. Additionally, Jonathan was the CEO of Eagle Hospitality Trust, a 13 hotel-property private REIT. Jonathan has led the sales of single assets and portfolios of 88 hotels for over $2.2 billion of value. Before founding JF Capital in 2004, Jonathan was an investment banker at Bear Stearns in the Gaming, Lodging and Leisure Group. Jonathan began his career as a CPA at Price Waterhouse.

Jonathan has over 20 years of experience in the real estate and lodging sector. He has worked on numerous M&A and financing transactions involving well over 2,000 hotels and over $25 billion of transaction value. Of the $25 billion, $24 billion was completed as an advisor and $1 billion was completed as a principal. He has been actively involved with mergers and acquisitions of public and private companies, portfolio sales and single asset sales, equity financings, high yield financings and mortgage financings. Jonathan has extensive hospitality experience as an agent, advisor, principal, owner, borrower, guarantor, franchisee, lender and asset manager.

Jonathan received a BA in economics with high honors from Rutgers College and an MBA from Columbia Business School with a concentration in Real Estate Finance. Jonathan has been an adjunct professor at NYU's Real Estate Institute and is an active lecturer and panelist at industry events. Additionally, Jonathan sits on the board of the Boutique & Lifestyle Lodging Association.

Guy Maisnik
Partner, Vice Chair Global Hospitality Group
Jeffer Mangels Butler & Mitchell LLP

Guy Maisnik has nearly three decades of commercial real estate transactions with a strong expertise in hotels and finance. He is a partner and Vice Chair of JMBM's Global Hospitality Group®, a senior member of JMBM's Chinese Investment Group, and a partner in the Real Estate Department. Guy advises clients on hospitality transactions, with both a practical business and legal focus, representing buyers, sellers, lenders, opportunity funds, special servicers, REITs and developers in hotel transactions, joint ventures, hotel management and franchise agreements, buying, selling and ground leasing of hotels, complex mixed used development and fractional and timeshare structuring.

Guy has also assisted lenders and mezzanine lenders, including EB5 regional centers and investors, with structuring their hotel lending programs and documentation. Guy's practice is equally domestic and foreign, where he advises on matters throughout the United States, Mexico, Canada, South America, Caribbean, Eastern and Western Europe, Australia, Middle East and Asia. Guy also has significant experience in structuring capital raises through Chinese and EB5 investments, and structuring workable condo hotel and resort trust solutions for domestic and foreign buyers and investors. He has been recognized in The Best Lawyers in America®, California Real Estate Journal's Best Real Estate Lawyers, Super Lawyers® for both Real Estate and Business Law, Los Angeles magazine's Top Southern California Lawyers, as well as a Top Real Estate Lawyer in Real Estate Southern California magazine

Tara K. Gorman
Shareholder
Greenberg Traurig LLP

Tara K. Gorman focuses her practice on hotel acquisitions, operations, development and finance, general commercial real estate transactions, including commercial real estate acquisitions and sales, and office retail leasing.

Tara prepares and counsels clients, both domestically and internationally, regarding hotel acquisitions, financing, operations, development and finance, condo-hotels, hotel management agreements, license and branding agreements, restaurant management agreements, water park and casino agreements, real estate finance documents, purchase and sale agreements, property management agreements, corporate formation, business improvement districts, vendor agreements, marketing management agreements, website service agreements, telecommunications license agreements, and commercial office and retail leases. Tara has represented institutional investors such as life insurance companies and pension funds in connection with their real estate investments, as well as governmental and quasi-governmental agencies with respect to their real estate holdings.

Tara is a graduate of University of Maryland, where she received a B.A. and M.B.A. and she holds a J.D. from Georgetown University of Law.

Outline

1. Traditional Preferred Return / Promoted Interests
2. Carried Interest
3. Cash Flow Splits
4. Risk Allocations
5. Guarantees
6. Major Decisions
7. Exit Provisions

- What are current trends in the use of joint ventures to provide financing for hotel development and acquisitions?
- How are preferred return/promoted interests structured?
- What unique issues in hotel joint ventures impact risk allocation provisions?

1. TRADITIONAL PREFERRED RETURN / PROMOTED INTEREST JOINT VENTURES

Introduction

Why Joint Venture?

- Need capital
- Need a home for capital
- Need property
- Want the Operator position
- Potential alignment of interests
- Merging of skillsets

What is the Form of Entity?

- Limited Liability Company
- Limited Partnership
- S-Corp

Capital Contributions

- JV agreement will specify the percentages that each partner is required to contribute (sometimes will also specify the initial dollar amounts)
- Future contributions may be made on a pro rata basis in line with the equity percentages
- If one partner does not fund when required, the other partner can often times fund the necessary amount and will dilute the equity percentage of the non-funding partner
  - Usually the dilution will be punitive, in that the percentage decrease may be 120-150% of the amounts funded
  - Dilution may be in the form of a loan to the partnership which takes priority in repayment from distributable cash flow
  - Need to consider whether Dilution that is highly punitive an unenforceable penalty?

Impact of Dilution Formulas

- Investment amount might change due to the application of a penalty dilution formula related to a contribution default
- Dilution formulas typically give the contributing partner credit for over 100% or more of the default contribution (i.e., the defaulting partner's share of the capital call that is advanced by the contributing partner)
- They generally do not result in the capital deemed invested, rather the partnership percentages are simply adjusted

Pre-Formation and Formation Costs

- If the Sponsor has brought the project to the financial partner, it may have considerably more time and expense associated with its pursuit of the project
- Generally, the financial partner will limit the pre-formation and formation costs that are capitalized to specific costs that are scheduled and approved before the partnership agreement is signed
- Sponsor may have tax benefits even if not covered in JV Agreement

Potential Fees

- Acquisition Fees
- Disposition Fees
- Development Fees
- Financing Fees
- Asset Management Fees
- Management Fees
- License / Franchise Fees
- Technical Services Fees
- Pre-Opening Fees
- Purchasing Fees
- Guaranty Fees

Impact of Fees

- Fees may cause misalignment of interest depending on each partner’s Equity Investment amount

- Fees are usually not considered in the cash flow calculation for purposes of calculating an IRR to the Capital Partner as the fees are normally paid to the Sponsor / Managing Partner

Other Issues

- Partner Loans
- A loan is not the same as a contribution and among other matters, requires priority payment
- Legal differences exist between a Loan and Equity
  - Interest is tax deductible
  - Creditor priority issues
  - Secured or unsecured
  - IRS may look through the form of capital and determine that what is called equity is actually a loan or vice versa

What is a Waterfall?

- A Waterfall is the order in which available cash flows are distributed to partners
  - Can be highly customized based on the specifics of a deal
  - Can be different for operating cash flows versus capital event (sale, refinancing) cash flows

Promotes

What is a Promote?

Sponsors receive promotes as incentives to deliver superior financial performance. The concept of a promote, is that upon achieving superior returns, the interests of the Sponsors would be “promoted” and at a higher level than its stated nominal capital interests.

- A promote is paid as excess distributions to the Sponsor at a level greater than the Sponsor’s capital contribution

Why Would Anyone Earn a Promote?

What is a Promote?

A Promote is sometimes called a “carried interest”

- A Promote is a type of incentive compensation payable to a Sponsor and is earned for creating value:
  - Identifying or securing an attractive deal;
  - Bringing useful relationships, expertise, experience or knowledge to a transaction;
  - Providing value added asset, construction or development management services;
  - Providing loan guaranties or completion guarantees (which may not only involve a greater share of risk, but may also get a lender to provide cheaper debt that makes the partnership more profitable);
  - Bearing financial responsibility for cost overruns

How Is the Promote Calculated?

- The promote is usually calculated as a percentage of the distributable cash flows after the Financial Partner has achieved a preferred return on their capital, and a return of that capital

- There may be several tiers of promote calculations

- Promotes may not be in place in the case of an operator who makes a sliver equity investment, where the operator may receive an incentive fee rather than a promote

When Is the Promote Received?

- Usually the Promote is received when there is cash available to distribute, and the required preferred returns on and of capital have been received
- The JV agreement may specify when or how often distributions are to be made
- Loan documents may preclude an earned promote from being distributed until achievement of certain credit statistics

What Are Preferred Returns?

- A preferred return is a calculated amount, usually a percentage of the capital invested
- Usually calculated annually, but sometimes monthly, and may be compounded
- Preferred returns are designed to measure the required invested rate of return on an investment, before a Sponsor can receive a promote

Other Promote Calculation Issues

- Excessive leverage can lead to a faster return of equity and of preferred return on that equity which increases the promote
- Short holding period can trigger a very high promote
  - Many sophisticated opportunity funds will also impose a minimum equity multiple in addition the IRR calculation

What is an IRR?

- IRR is a metric used in financial analysis measuring the profitability and returns of potential and actual investments
- XIRR is often used; XIRR is a Microsoft Excel function that calculates IRR based on the precise dates of cash inflows and cash outflows
  - The normal IRR function in Excel assumes that all cash inflows or outflows are actually received or made on the last day of the relevant time period, and can mis-state the true IRR

Outflows

What are the outflows for IRR calculations?

- Contributions to the partnership
- However, there are many possible exceptions and additions:
- Partner loans
- Fees received
- Contribution of services

Crossed Promotes & Clawbacks

Crossed Promotes

- When a Financial Partner and a Sponsor are involved in more than one hotel and the promote is earned on the performance of the entire portfolio

Clawbacks

- A clawback is when a promote payment that has been received is owed back to the partnership or the other partners as subsequent performance was weaker or the partnership required additional contributions / investment

How Can the Promote Be Lost?

Losing Promote for Cause

- If Sponsor defaults on major obligations or engages in improper conduct
- Upon removal, the Sponsor may be converted to a silent capital partner which receives future distributions with the other partners on a pro rata basis in accordance with its capital account

Losing Promote Without Cause

- Some Financial Partners will reserve the right to remove the Sponsor as administrative partner without cause or for a failure to meet certain identified performance standards that may have nothing to do with the Sponsor's performance

Promote Hurdles—Whose Investment?

Financial Partner's Investment: IRR on its capital investment and not the project IRR or the Sponsor's IRR

- Project IRR and Sponsor's IRR will be greater than the financial partner's IRR as soon as promote distributions begin
- In the context of hurdle calculations, the purpose of the IRR calculation is to determine whether and when promote distributions should be made

Promote Hurdles — Unleveraged vs. Leveraged Returns

Most hotel deals utilize mortgage financing. Distributions and Hurdles are net of loan interest and principal payments

Unleveraged Return

- Some financial partners set their hurdles based upon the performance of the project on an *unleveraged* basis despite financing
- Benefits from the financing are shared by the partners in accordance with their equity interests
- Value associated with favorable financing usually a function of interest rates not the Sponsor

Promote Hurdles — Unleveraged vs. Leveraged Returns

Leveraged Return.

- If the promote hurdle is calculated on a leveraged basis, then it relates only to equity interests
- Financing with an interest rate that is less than the preferred return hurdle rate will accelerate the achievement of the hurdle and the payment of the promote
- Tension between the financial partner and Sponsor over how much and when financing should be obtained by the partnership
- Additional financing may increase the financial partner's IRR

Preferred / Promote Structure

What is the current range of preferred and promoted returns given different Sponsor equity percentage investments?

- At a 15% Sponsor Equity Contribution, a typical promote structure we see in the market today is as follows:
  - Pari Passu up to an annual Internal Rate of Return (IRR) hurdle rate of 10-12%
  - Promote of 10 – 15% above a 10 – 12% annual IRR hurdle (optional)
  - Promote of 20 – 25% above a 15 – 17% annual IRR hurdle
  - Promote of 30 – 35% above a 20 – 22% annual IRR hurdle

- While each deal is negotiated individually and the components are on a sliding scale, you might see different pref / promote structures that look like the following:

	Hurdle			Promote		
Equity Invested	**1st Tier Pref**	**2nd Tier Pref**	**3rd Tier Pref**	**1st Tier Promote**	**2nd Tier Promote**	**3rd Tier Promote**
10%	10-12%	15-17%	20-22%	10-15%	15-20%	25-30%
15-20%	10-12%	15-17%	20-22%	10-15%	20-25%	30-35%
25%	10-12%	15-17%	20-22%	10-15%	25-30%	35-40%

2. CARRIED INTEREST

Carried Interest Overview

- "Carried Interest" is used broadly and can mean different things depending on context
- Generally speaking, a Carried Interest is the equity in a deal given to or allocated to someone greater than their actual equity contribution/percentage interest
- A carried interest may be granted to someone who was instrumental in facilitating or creating a deal
  - Finder, broker, introducer, attorney
- A finder or broker may be granted 10% or 20% of the equity in a transaction, without putting in any equity or in connection with putting in a minimal amount of equity

3. CASH FLOW SPLITS

Cash Flow Splits

- Many joint ventures have a cash flow distribution structure which specifies cash flow splits
- The language in the Distributions section of the JV Agreement will specify the splits:
  - Example: Distributable cash flow is split 90% / 10% until the achievement of a certain IRR or a certain return threshold
  - After the threshold is achieved, the cash flow will then be split 70 / 30%
  - Capital event proceeds may be split the same way or a different way than operating cash distributions

4. RISK ALLOCATIONS

Risk Allocations

There are numerous ways to allocate risk within a JV:

- Pursuit costs or pre-development costs may be provided for with the Sponsor bearing a larger share than their Equity Percentage
- Funding cost overruns for a development or a Property Improvement Plan (PIP) may be allocated disproportionately to the partner overseeing the work
- Certain fees to sponsors that provide services may be subordinated to a certain level of performance return
- Sponsor representations in the Joint Venture Agreement

Other Issues

- Comfort Letters with Brands
- Liquor Licenses
- Employer / Management Company Complications
- Franchisor Property Improvement Plans
- Assignment / Transfer
- Tax
  - Hidden cash flow / phantom income
  - Trapped / cash despite taxable income
  - Transfer of Property into JV entity
- Bankability – creating an effective SPE structure for financing
- Assignment of material contracts
- Dead lock issues
- Change of control triggers

5. GUARANTEES

Guarantees

Guarantees required may include:

- Completion
- PIP Completion
- Debt repayment
- Non-recourse carve-out
- Environmental
- Franchise

Guarantees

- Guarantees are often provided by the Sponsor, though sometimes the Sponsor may not be willing to provide all the guarantees or does not have sufficient net worth or liquidity
- Certain guarantees may be provided by the JV, depending on the amount of Equity Value in the property owner entity
- If the financial partner is providing guarantees, it may then be indemnified by the Sponsor, or may receive a fee for providing such guarantees

6. MAJOR DECISIONS

Major Decisions

- Day to day management is generally handled by the Sponsor pursuant to an approved operating and capital budget
- The joint venture agreement will spell out in detail a number of decisions referred to as the Major Decisions
- Generally, the Major Decisions need to be unanimous, or if multiple partners, must be a supermajority

Major Decisions

- Major Decisions will often include:
  - Sale of hotel
  - Refinancing of hotel
  - Change in management company
  - Change in brand / franchise
  - Approval of General Contractor
  - Bankruptcy
  - Approval of GMP contract
  - Admission of additional partners
  - Consent to guarantees (debt, franchise, other)
  - Entering into material leases
  - Labor neutrality agreement

7. EXIT PROVISIONS

Unwind Provisions

It is critical to determine how the partners in a joint venture can exit their investment:

- There are a number of ways to create unwind provisions for a JV
- There is often times an asymmetry in the desired holding period between the partners

The most common unwind provisions are:

- Buy / Sell
- Put / Call
- Forced Marketing
- Drag Along / Tag Along Rights

Unwind Provisions

JV documents may not address all of the ancillary issues involved with an unwind or transfer or interests:

- Replacement guarantees (financing/franchise, lease)
- Unfunded obligations
- Impact of services contracts (if a partner is also the operator)
- Transfer provisions under franchise agreements, lease agreements, loan agreements
- Liquor license transfers

Unwind Provisions

- Usually there is a period of time during which neither party can force or trigger an unwinding of the venture
  - For an existing asset, it is often 2 years from acquisition before any party can trigger the unwind provisions
  - For a development deal, it is usually 2 – 3 years after the opening of the hotel so that the property has time to ramp up its operations and stabilize

Buy / Sell

Usually with a Buy / Sell:

- Notice provided by one partner specifies the price and the key material terms under which it would acquire the other partner's interest

- The receiving party has a finite amount of time (usually 30 or 60 days) to specify that it will accept the terms, or to acquire the Offeror's interests on the same terms / valuation

Put / Call

Similar to a Buy / Sell provision, a Put / Call structure may come into place after a triggering event

- One partner notifies the other than it will “put” or sell its interest to the other partners, or to the partnership
- One partner notifies the other that it will “call” or purchase the other partner’s interest

Often times, a Put / Call is triggered after the death or incapacity of one of the partners or after the occurrence of some designated major event

Forced Marketing

Generally, there is a period of time prior to any ability to execute a forced marketing of the hotel

- The documents may provide for a marketing of the hotel or of the specific partner's interest

- The documents will usually provide for a notice whereby the receiving party can purchase the hotel or the interest at a specified price, and if it elects not to then the offering partner can market the interest/property

Drag Along / Tag Along

Drag Along Rights

- Allows a majority partner to compel the minority partner to join in the sale of the venture
- The minority partner gets "dragged along" on the same price, structure, and conditions as the majority partner

Tag Along Rights

- If majority partner sells its interest, the minority partner has the right to literally "tag along" and sell its interest as part of the same transaction
- Protects the minority shareholder

Promote Structure

- The following illustrates the promote structure for the equity partnership (90.0% LP Partner Equity, 10.0% GP Equity)

The distributions are:

- First, pari passu until the achievement of an 10.0% preferred return to the GP Investor and LP Investor, and thereafter a 15.0% promote to GP Investor
- Second, pari passu until the achievement of an 15.0% preferred return to the GP Investor and LP Investor, and thereafter a 25.0% promote to GP Investor
- Third, pari passu until the achievement of an 20.0% preferred return to the GP Investor and LP Investor, and thereafter a 35.0% promote to GP Investor

LP Cash Flow		**2015**	**2016**	**2017**	**2018**	**2019**	**2020**
Equity (90%)		($11,043)					
Preferred Return			($214)	$293	$1,455	$1,645	$24,350
Residual Cash Flow			0	0	0	0	0
Total Cash Flow		**($11,043)**	**($214)**	**$293**	**$1,455**	**$1,645**	**$24,350**
Cumulative Cash Flow		(11,043)	(11,257)	(10,965)	(9,510)	(7,865)	16,484
LP Returns							
Total Profit	$16,484						
IRR	20.9%						
NPV (15.0%)	$2,985						
Equity Multiple	2.49x						
GP Cash Flow							
Equity (10%)		($1,227)					
Preferred Return			($24)	$33	$162	$183	$2,706
Promote			0	0	0	0	4,627
Total Cash Flow		**($1,227)**	**($24)**	**$33**	**$162**	**$183**	**$7,332**
Cumulative Cash Flow		(1,227)	(1,251)	(1,218)	(1,057)	(874)	6,458
GP Returns							
Total Profit	$6,458						
IRR	45.2%						
NPV (15.0%)	$2,630						
Equity Multiple	6.26x						

Jonathan Falik

JF Capital Advisors

(917) 238-6917
jonathan@jfcap.com

31 Union Square West
New York, NY 10003

Tara K. Gorman

Greenberg Traurig LLP

(202) 530-8519
gormant@gtlaw.com

2101 L Street, N.W. Suite 1000
Washington, DC 20037

Guy Maisnik

Jeffer Mangels Butler & Mitchell LLP

(310) 201-3588
mgm@jmbm.com

1900 Avenue of the Stars, 7th Floor
Los Angeles, CA 90067