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Insights

IMPROVING LIQUIDITY FOR ASIAN REAL ESTATE INVESTORS - PART 1

PARTIAL SELL-DOWNS AND REAL ESTATE JOINT VENTURES (PART 1 OF 2)

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SUMMARY

Three years after the outbreak of COVID-19, restrictions have finally eased in Asia. However, investors in the region are still feeling its effects as well as headwinds caused by higher interest rates, rising inflation, supply chain constraints and tightening labour markets – not to mention the potential impact on the broader banking system of the recent failures of Silicon Valley Bank and Signature Bank in the US. These are challenging times and Asian real estate investors have certainly not been immune to these challenges.

Investors in many locations (including Asia) are experiencing property market slumps partly driven by unfavourable revaluations by lenders and banks of mortgaged properties and the calling in of loans or the anticipated calling in of loans. This is a time when property owners may need to consider ways to de-risk their investments and to improve liquidity by divesting (wholly or partly) of their real estate assets. A common route to effect such divestiture is to sell down part of the asset and form a joint venture with the buyer. Alternatively (or as a hybrid), an owner may sell the whole or part of its properties – but on the basis that it receives a lease back immediately on completion so that it can continue to use the property (or properties). In our three part series, we explore some of the key issues involved in these joint venture and sale and leaseback arrangements for Asian real estate investors.

INTRODUCTION

In this article, we discuss how Asian real estate investors can sell down their existing ownership interests to de-risk their investments and provide liquidity but at the same time retain a meaningful interest in the asset. A common route to effect such divestiture is to sell down part of the asset (directly or indirectly) to a new capital partner (or in some cases, to a new operating partner) and form a joint venture with such partner. However, such joint venture arrangements can be complex.

Different considerations apply depending on how the arrangement is structured, the nature of the underlying asset and its funding requirements (e.g. does the asset require significant capital expenditure or is it fully stabilised?), the percentage of the interest being sold down, the proposed holding period and, of course, the exit strategy.

In this first part in our two part article on sell-downs and real estate joint ventures, we explore four of the key issues that Asian investors should consider when contemplating a partial sell-down and joint venture: (i) structure; (ii) governance and control; (iii) conflicts of interests; and (iv) deadlock resolution mechanisms.

1. STRUCTURE

The term “joint venture” (or “JV”) is broad and it can denote any number of business arrangements between two or more parties with different structures (such as limited companies, partnerships, unit trusts and unincorporated contractual arrangements). Factors which may influence the structure include nature and complexity of the project, duration of the collaboration, the number and jurisdictions of participants, tax and accounting considerations and relationships with external stakeholders.

Because of their tax favourable environments, British Virgin Islands, Cayman Islands and Bermuda have traditionally been popular choices amongst Asian investors for establishing incorporated joint venture vehicles. But this is not always the case. In Hong Kong, for example, collaboration with businesses in mainland China and acting as a gateway for international investors into the Chinese market constitute a prevailing part of investment activity. In such a Hong Kong-mainland China cross border joint venture, it is common to see an incorporated entity formed in Hong Kong as the “offshore” platform linking international investors for the purpose of funding, which will then have an “onshore” subsidiary in the PRC conducting substantive business operations of the joint venture, such as holding and developing real estate in the PRC.

2. GOVERNANCE AND CONTROL

Majority investors typically have control over the decision-making of the JV through their majority shareholding and their right to appoint a majority number of directors on the board of the JV company. An inclusion of a list of “reserved matters” which require the consent of both JV partners (or the directors appointed by them) can help a minority partner (or a majority partner who is not involved in the day to day operation of the JV) to ensure that it has a veto right over more important decisions (such as the disposal of the underlying business or assets of the JV, acquisition of major assets or businesses, the cessation of business operation, dissolution of the JV company, alteration of any material terms in its constitution). Further, it should be noted that, in respect of a JV company incorporated in some of the more mature markets in the region (e.g. Hong Kong and Singapore), certain decisions, such as, altering the articles of association or constitution of the company, varying class rights or winding up the company, are statutorily prescribed to require

approval from a majority of at least 75% of the shareholders who are entitled to vote on the resolution.

It is relatively common in JV arrangements involving real estate, for the operating partner (who is often a minority shareholder) to be given control over the day-to-day operation of the investment or project. This is achieved by its affiliate acting as the manager of the JV by entering into management agreements with the JV company. This is common, for example, in JVs involving financial sponsors or private equity real estate funds where the majority shareholder is typically the financial sponsor or fund which contributes the majority of the capital to the venture. It may not be involved in the day-to-day management and relies on its operating partner (typically the minority shareholder) to manage the venture on a day to day basis and bring to bear its expertise in developing and managing the asset. The drawing up of the list of "reserved matters" under this type of situation is advantageous to the majority investor as it is has the ultimate say on all significant decisions.

As well as having rights over fundamental decisions, the minority or non-operating partner should also consider what rights it has if its JV partner decides to exit. Having a pre-emption right or a right of first refusal may be appropriate and will give a party a right to be offered the shares of the other party (or the asset itself) before the partner looking to exit is allowed to sell them to a third party. This may be useful in situations where the minority party has access to sufficient resources to acquire the majority interest (or the whole asset itself). Alternatively, a tag-along right (and/or a co-sale right) will allow the minority party to sell its interest at the same time as the majority party sells to a third party buyer. This right can be important as it ensures that a minority party does not become stuck in a JV with a third party which it may not wish to deal with (e.g. a competitor) when its original partner chooses to exit.

3. CONFLICTS OF INTEREST AND DIRECTORS' DUTIES

While there will hopefully be strong alignment among the shareholders as they share common goals at the time the JV is established, there will also be some matters where the interests of the partners may not be aligned. It is of course prudent to plan ahead and agree at the outset how such conflicts will be managed.

The directors appointed to the board of the JV company should be mindful of the fiduciary duties they owe to the JV company, including their duty to avoid conflicts of interests (notwithstanding that they may have been appointed by a particular JV partner). Typically, JV partners have the right to appoint directors to the board of the JV company, which is ultimately responsible for decision-making and overseeing the venture. Pursuant to common law principles (e.g. Hong Kong and Singapore), these directors must act honestly and diligently, showing the JV company their highest loyalty, acting in good faith and in the JV company's best interest. Such fiduciary duties of the directors are owed to the JV company alone, and not to the shareholders despite the directors being appointed by and affiliated with respective shareholders.

Further, directors are generally required to disclose any material interests which they or the shareholders appointing them have in a matter and they may be barred from voting on such a matter. For example, under Hong Kong company law, it is a statutory requirement for directors to declare both the *nature* and *extent* of his or her interest to the other directors where the director is "*in any way, directly or indirectly, interested in a transaction, arrangement or contract, or a proposed transaction, arrangement or contract, with the company that is significant in relation to the company's business, and the director's interest is material*". Whether or not such interested director would be barred from voting on relevant resolutions depends on the terms of any shareholders' agreement as well as the articles of association or constitution of the JV company.

4. DEADLOCK

How deadlocks are handled is critical not only in the context of a traditional 50:50 JV, but also in the context of "reserved matters" where consent from both JV partners is required. In Asia, as elsewhere, there are a variety of ways to resolve deadlocks (and parties may choose to use a combination of these different mechanisms).

An "escalation clause" (also known in some jurisdictions as a "gin and tonic" clause) provides for an escalation of the issues giving rise to the deadlock to more senior individuals (e.g. the chairperson or chief executive) of the JV partners. These more senior individuals are typically not involved in the day to day operation of the JV. Accordingly, they may be able to take a detached and broader view of the issue having regard to the overall interests of the parties. This may also serve as an added incentive to the management to agree upon issues themselves rather than having them escalated to their respective superiors. This clause may not be as useful where the JV participants are a small number or closely held companies (e.g. where the chief executive of one of the JV partners is involved in the running of the JV). Alternatively, or in addition to the escalation clause, the JV parties may look to an independent third party to resolve the matters by including a mediation clause or an expert determination clause.

While the above clauses are mechanisms designed to resolve the subject matter leading to the deadlock, there may also be more powerful tools available to the parties which involved fundamental changes to the JV or bringing an end to the JV. For example, in the context of JVs involving Asian real estate (as elsewhere), it is relatively common for a party to have the right to buy out the other party, or alternatively, to offer to sell its shares to the other party. Alternatively, the parties may have a right to appoint a broker or agent to market the asset and find a third party buyer. Finally, as an ultimate backstop, the parties may have the right to wind up the JV company (either consensually or by applying to the court in the relevant jurisdiction).

CLOSING REMARKS

Selling down interests in a business or company involving real estate in Asia can be complex. We have focused on four of the key issues that Asian investors should bear in mind where

contemplating a partial sell down: structure, governance and control, conflicts of interest and deadlock. There are, of course, other issues to consider and in the next article we will discuss some of the key economic considerations such as: (i) funding, (ii) distributions, (iii) waterfalls and (iv) exit.

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