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Case Study: SFR Rehab Joint Venture vs. Private Mortgage Structure

The joint venture structure is an extremely flexible vehicle for doing business in real estate on a limited or project-by-project basis with a partner. Accordingly, there are many kinds of joint venture structures. This case study will speak about: (i) a typical joint venture structure between two parties for the purchase-renovation and sale of a single-family residence in New York; (ii) between two parties with one passive partner providing the funding for the project and the other providing services and serving as the active partner managing the renovation.

In a typical private lender transaction, the Lender funds approximately 70% of the total project cost and receives a fixed return for its money. The Lender gets a mortgage on the property to secure the repayment of its loan. The Rehabber is required to put up 30% of the total project cost and pays interest to the Lender during the term of the loan. After the payment of the Lender's interest, all the remaining profit on the project goes to the Rehabber.

In a typical joint venture transaction, the Lender funds 100% of the total project cost and receives an equity participation (30%-40% of the net profit) with a minimum return to the Lender (10-11%) for downside protection on the Lender's money. The Rehabber is typically only required to fund an appraisal and some closing costs. The Rehabber is entitled to the remaining equity participation (70% - 60%) as its net profit.

Security For the Lender.

In a typical private lender transaction in New York, the Lender receives a mortgage on the property and a personal guaranty from the Rehabber. In the event of default, the Lender's remedy is to foreclose on the property and, if necessary pursue a deficiency judgment against the guarantor. In New York State, these are lengthy processes that take years to resolve. Because of the time and cost it takes to come to a resolution, most Lender's will insist on no more than a 70% loan-to-value ratio to work in an equity cushion to address these challenges to enforcement.

In a typical Joint Venture Structure, the Lender is the deeded owner of the property, and the Rehabber serves as a project manager for the project with a revocable license to complete the rehab. In the event of default, the Lender need only terminate the Rehabber and finish the project on its own. Enforcement in the event of default is completed in a matter of months, not years through a licensee summary proceeding (like a landlord-tenant eviction action).

In addition, since the Rehabber is serving as a project manager, it has a fiduciary obligation to the Lender under New York Law which imposes a higher obligation upon the Rehabber to proceed in the best interests of the Lender throughout the project. The Rehabber's interest in the property is protected with the power to lien the property to the extent of amounts it contributed in the event they are wrongfully terminated. Since the Lender has more control over the project and can more quickly resolve defaults, they're more comfortable funding up to 100% of the total project cost.

Flexibility of Terms

The joint venture structure is appealing to the Rehabber because they can put less of their own money into the project. This enables the Rehabber to leverage themselves further and have more projects going at once. Also, the terms of the joint venture are much more flexible than a straight mortgage which enables the parties to negotiate an equity split, straight interest or some hybrid form which uses a mixture of equity and interest.

The joint venture structure is appealing to the Lender because they have more security in the event of a default since they will be the deeded owner of the property and able to terminate the relationship with a defaulting Rehabber in a matter of months rather than years. Also, the flexible terms enable the Lender to negotiate an equity participation in the project to increase its return on investment.

Since the Lender has greater control, they tend to be easier about making construction disbursements with greater speed and efficiency.

Enforcement of Obligations

If the Rehabber defaults on its obligations, there's no need for the Lender to commence a foreclosure proceeding. The Rehabber's legal status is the same as an independent contractor, or an irrevocable licensee. The Rehabber has no independent possessory or equitable interest in the property. This means that the Lender need only terminate the relationship and the Rehabber would be forced to immediately leave the project. If the Rehabber refuses to leave, then the Lender can commence a licensee eviction proceeding which is similar to the eviction of a tenant. That type of proceeding can be resolved in a matter of months, instead of years as is typical in a foreclosure. For this reason, Lenders like the additional security that quick enforcement of obligations can provide.

If the Lender defaults on its obligations, or wrongfully terminates the relationship, the Rehabber (in a typical joint venture agreement) would be entitled to the reimbursement of its financial interest in the project. This financial interest is usually defined ahead of time, and after any offsets for damages caused by the Rehabber, could become a lien on the property if the Lender refuses to pay. So, while the Rehabber maintains no equitable interest in the property, its financial interest can be pre-defined and secured.

Downside of the Joint Venture Structure

<u>Uncommon Structure</u>. Unlike a typical mortgage structure, the joint venture arrangement is not as common, so the parties might not be as comfortable with the unfamiliar structure.

<u>Less Rehabber Skin in the Game</u>. With the Lender funding all or almost all the project, the Rehabber might not have as much of an incentive to follow-through on the project if it seems that they won't make as much money as they anticipated. If the Rehabber walks away from the project, then the Lender is left to complete the project on its own. Some Lenders don't have the means to complete a rehab project on their own.

<u>Rehabber Has Less Control</u>. The legal structure takes much of the control over the project out of the Rehabber's hands. While the typical joint venture agreement does offer some protections against the lender wrongfully terminating the relationship, there's not much to prevent the Lender from immediately removing the Rehabber from the project if they are not performing adequately. Some Rehabbers might not want to give up this kind of control.

How We Can Help.

Most joint venture arrangements that we assist clients with have been extremely successful for both the Lender and the Rehabber. Like any situation in which you're doing business with others, it all comes down to the people and how well they work together. Learning the favored terms and expectations of both sides **up front** is crucial. Our process of determining the terms of the joint venture agreement goes a long way toward fleshing out these expectations from the beginning. This helps both parties decide if they will be a good fit to work together before money changes hands.

We use the joint venture structure exclusively for some of our clients and offer a "soup to nuts service" serving as attorney for the project. With this service we help both sides negotiate an acceptable agreement template, then we handle both the purchase and sale closings. In addition, we have systems in place to handle the efficient disbursement of construction money and account for all proceeds and joint venture disbursements to the parties upon the sale of the property.

In the following pages I've provided a case study using figures from a recent typical joint venture transaction we completed so that you can see how this structure works in real-life. If you'd like to learn more about whether the joint venture structure could work for you, please reach out to me at the number above, and I'd be happy to discuss further.

-Jim Clark

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Assumptions.
Purchase Price: $161,500
Total Project Costs: $63,500 (excluding purchase price)
Type of Project: SFR Rehab and Flip
Length of Project: 6 months
Sale Price: $275,000
Lender Contribution: Loan- $192,500, JV $225,000
Rehabber Contribution: Loan $32,500, JV $0
Loan Terms: Lender Funds 70% of total project cost, 12% interest only, no up-front points
JV Terms: Lender funds 100% of total project cost, 60% to Rehabber, 40% to Lender with 11% minimum Lender return

Rehabber Cost Comparison.

	Loan Structure	**JV Structure**
Lender Appraisal Fee	$500	$500
Rehabber Contribution	$32,500	$0
NYS Mortgage Tax	$2020	$0
Mortgage Recording	$700	$0
Attorney Fees (combined)	$3500	$4500
Mortgage Sat Fee	$550	$0
Title Closer Pickup Fee	$250	$0
Lender Title Policy	$850	$0
REHABBER CASH CONTRIBUTION:	**$40,870**	**$5000**

***Rehabber needs $35,870 more cash with the Loan structure. ***

Net Proceeds Comparison.

	Loan @ 12% Interest	**JV Structure**
Project Gross Profit	$40,000	$40,000
Interest to Lender	$11,550	$0
Equity Participation to Lender	$0	$18,600
Equity Participation to Rehabber	$28,450	$21,400

***Lender's net proceeds are $7,050 more with the JV Structure. ***

Return on Investment Comparison.

	Loan @ 12% Interest	**JV Structure**
Cash Contributed by Rehabber	$40,870	$5000
Cash Contributed by Lender	$192,500	$225,000
Rehabber's Net Profit	$28,450	$21,400
Rehabber's ROI	**70%**	**428%**
Lender's Net Profit	$11,550	$18,600
Lender's ROI	**12% (annualized)**	**16.5% (annualized)**

***The JV Offers a Higher Return on Investment for Both the Rehabber and the Lender. ***