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Chase For Property Fuels More Forward Real Estate Deals

By **Andrew McIntyre**

Law360, New York (January 07, 2015, 2:30 PM ET) -- With an extraordinary amount of domestic and foreign capital chasing a small amount of available real estate in hot U.S. markets, institutional investors are increasingly opting to purchase properties before ground has been broken, and such forward deals come with specific construction, financing and leasing considerations, lawyers say.

Particularly in markets like New York and San Francisco, insurance companies, real estate investment trusts, private equity firms and other investors are finding a scarcity of available properties. Looking to lock in current costs and returns, they are increasingly buying yet-to-be-built properties, a return to a practice that was common prior to the crash.

“There was a lot of that at the height of the market, where companies were trying to lock in deals and buy them in advance and get the transactions lined up,” said David Hymer of Sheppard Mullin Richter & Hampton LLP. “Just recently, we’ve started to see more activity.”

Such deals, ostensibly a purchase and sale agreement that takes effect before the building has been built, are also commonly called forward commitments. Buyers typically put a certain amount down at the time of signing and agree to pay the remainder of the purchase price by the specified time the building is delivered.

But given that there are no bricks and mortar in the ground and no tenants on site at the time of the agreement, there are various considerations and negotiations unique to such agreements.

One is the question of leasing. The agreement typically lays out what role the buyer and seller will have in the leasing process, and what requirements the seller will have for, say, leasing a percentage of the property by a certain time in the construction process.

Such forward deals typically require the seller to have a certain percentage of the building, sometimes 65 percent or 70 percent, or even 80 percent, leased by a certain time in the construction phase.

For buyers, knowing a trustworthy tenant will occupy some or all of the building is an important consideration, and something buyers often require in such deals.

“The institutional investor is going to want to know who the tenant is,” said Raymond J. Werner of Arnstein & Lehr LLP. “What makes the deal go is the creditworthiness of the tenant.”

Another issue that's heavily negotiated at the time of purchase is construction risk. While such deals can help a developer obtain financing, they also come with the risk that the financing will fall through.

One of biggest concerns in such deals is whether the project will be completed on time, a question that's intricately tied to its ability to obtain and maintain financing. Part of the negotiation process lays out the terms for payment as well as provisions should certain milestones — payment, financing or construction — not be met.

But despite these and other risks, companies are increasingly getting involved in such deals. And unlike a decade ago, companies are now considering all major real estate asset classes.

"Traditionally, I've seen it more for industrial and high-quality industrial … or heavily preleased office," said Jesse Sharf of Gibson Dunn. "Of late, I've seen it more frequently for multifamily and especially hotel. It speaks to the attractiveness of those sectors."

GLL Real Estate Partners GmbH, a German real estate firm, did three such deals in the last year — two in Denver and one for an Amazon.com Inc. building in the Seattle area, said Michael H. Liever of Orrick Herrington & Sutcliffe LLP, who represented GLL on those deals.

Life companies such as New York Life Insurance Co. are also among the many companies also doing such deals, Liever said.

"Part of the reason this is happening is that people are going further out on the risk spectrum to bring in deals that they can live with," Liever said. "Institutional investors, private equity, REITs, private funds, life insurance companies go into these deals and take on a little more risk. It's a way to lock up deals that aren't up and running."

That so many more types of players are getting involved than did a decade ago speaks also to the competition today for real estate and the confidence in the market in core areas.

"It used to be an insurance company product," Sharf said. "Now REITs are doing it. Funds are doing it."

REITs in particular have specific considerations, since such companies have rental income and dividend requirements they have to meet in order to remain as REITs. Nontraded REITs in particular, which tend to have higher dividend requirements, have to be especially mindful, said David P. Lari of Cox Castle & Nicholson LLP.

But even REITs, with their added requirements, are finding that such deals make sense, given the fiercely competitive market for high-quality assets in key markets. Amid that competition, more and more companies are jumping at the opportunity to lock in property purchases.

"Cap rates can only go so low," Lari said, speaking of the ratio between net operating income and purchase price, a ratio that has fallen significantly in areas like San Francisco and New York. "If people are looking for returns, they're going to start exploring alternative ways to invest."

--Editing by John Quinn and Philip Shea.