CohnReznick

Unlocking Value: Strategic Equity Structuring to Maximize ROI

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Outline

- Purpose: Strategies for enhancing returns for joint-venture real estate deals.
- Players in a JV Deal
- Capital Stack
- Operating Agreement and Waterfalls
- Credits and Other Opportunities
- Conclusion

The Players

- Operator/General Partner
- Developer – where applicable
- Investor/Limited Partner

Parties' Priorities

a. Operator/General Partner:
   i. Earning their fees.

b. Developer:
   i. Aside from when developer is also GP, involvement is typically finished when project reaches CO.

c. Investor/Limited Partner
   i. Has to coexist with other two partners throughout the life of the deal.
   ii. Longest lasting commitment in the deal.

Goal

- Triage these separate interests in effectively structuring the deal.
- Deals typically structed based on ROI, cash on cash.
- Need to consider other strategies and implications.
- Not always about a cash-on-cash return.

Capital Stack

Current Debt Environment

A. Typical market terms now:
   1. 60-65% LTV
   2. 5 -7 term
   3. 25-year amortizing
B. Common pitfall: if a 10% sponsor (or an affiliate of sponsor) guarantees the debt, all the basis of the debt goes to the sponsor.
   1. Meaning investors may not have basis to immediately claim losses for tax purposes.
   2. Can create unanticipated capital gains.
C. Creates a gap in the capital stack, and the need for more expensive capital, e.g. Mezzanine Debt.

Mezzanine Debt

A. Treatment of Mezzanine Debt: Debt vs. Equity.
B. Understanding not only legal treatment, but tax impact.
C. Important to put the appropriate label and buttress accordingly for tax treatment.
D. Pitfalls associated with Preferred equity treatment:
   1. Can leave the door open to negative tax implications for the investor.
   2. Inability to guarantee their return of capital as first-out I the waterfall and allocation of losses.

Operating Agreement and Waterfalls

Waterfall Overview

- How income and cash returns are allocated.
- When these two scenarios don’t necessarily align.
- Area where we often see the largest disconnect.
- Not unusual for new hospitality operations to run deficits for an initial period.
  - Can be surprising for people who don’t typically invest in this space to hear the phrase passive loss.
  - For sponsors there are provisions that limit loss to half a million a year.

Carried Interest

- Incentivize the sponsor’s affiliate to better manage the investment.
- Receives a share when you get into the carry in the waterfall .
- Frequently misinterpreted
- Outlook: current administration is vocally opposed to carried interest.

Guaranteed Payments

i. Payment to a partner for performance of services or use of capital.

ii. Unstated corollary is a return.

iii. Classification as expense vs. return of capital. It is generally income to the sponsor and expense to the entity.

iv. This is also on the accrual basis regardless of basis of accounting.

   1. This can create phantom income to the sponsor.

Credits and Other Opportunities

Historic Tax Credits

i. First Timer Considerations:
   1. Understanding that these credits exist to preserve the buildings.
   2. It’d typically be cheaper to tear down the building and rebuild.

ii. Common Pitfall:
   1. The sponsor tries to get the credits themselves. Need to think about who is in the ownership line who can’t take the credits.
   2. You can’t specially allocate these so you would end up stuck.
   3. If you can take the credits, that’s the best route. But if you can’t, more beneficial to syndicate the credits and work with an investment bank or other partner.
   4. Understanding timeframe and timing issues.

Historic Tax Credits - Strategies and Considerations

- Beneficial to utilize a historic tax credit consultant and understand the economics of the deal.
- Put a team in place to handle aspects of compliance (e.g. cost certifications).
- Structuring as a master lease can create phantom income to the investors.
- There is a cost to these which is accreted to the capital stack.

Opportunity Zones

- Large swath of opportunity zones throughout the country.
- Attractive thing is pre-tax and after tax are the same.
- If I buy an interest in a hotel and my capital is working for 10 years, I don’t pay any tax when I sell the hotel.
- Lenders cannot foreclose, would need to forebear.
- For both Opp. Zones and Historic Tax Credits – nuances and issues related to structuring.

Conclusion

Conclusion

a. Structuring real estate deals isn't easy.
b. As debt market gets a little tougher, more sources of capital at play.
c. In the long run, it's mutually exclusive to get both cash returns and losses.
d. Understand the deal, the operating agreement and the tax attributes.
    i. Can be beneficial or can take a bite out of investors.
e. Most consult their attorneys, but not a lot of them consult their accountants.

Kyle Yantz

Senior Manager

11452 El Camino Real
San Diego, CA 92130

347-380-3633

kyle.yantz@cohnreznick.com

Kyle Yantz, CPA, is a senior manager at CohnReznick and is a member of the Firm's Commercial Real Estate and Hospitality practices where he serves as the San Diego Commercial Real Estate Market Leader. He has over ten years of experience providing assurance, accounting, and business consulting services to his clientele which include developers, owners, operators, private equity funds, and debt funds involved in mixed-use, office, industrial, multi-family, hotel, and retail projects. Kyle helps his clients execute meaningful transactions, monitor projects, and achieve critical goals with lasting impact.