Third-Party Reports in a Joint Venture Transaction

Preferred equity providers may offer other investment vehicles, such as mezzanine lending or joint ventures. In a joint venture transaction, the joint venture investor occupies a different position than it does as a preferred equity provider. Since the joint venture investor is part of the common equity in the transaction, it may have different needs when it comes to third-party reports. Here is a look at the reports may be required in such a transaction.

Appraisal

Just as in a preferred equity transaction, the joint venture investor likely will require an appraisal (typically leveraging the Senior Lender's report as mentioned in our article "Reducing Upfront Deal Costs for Preferred Equity"). In addition to the standard valuation approaches (cost/insurance replacement, income, sales), a joint venture investor may require a separate land value and/or a cost segregation analysis.

Typically, an appraisal report only gives a land value for a property under construction, where there are no improvements to value in place. However, a joint venture investor may need to understand the land value as separated from the improvements for accounting or reporting reasons, as an example. If the joint venture investor determines that it does require a land value, one avenue that avoids having to engage a separate appraisal report is to request an addendum with that value be issued to the joint venture investor.

Cost Segregation Analysis

A cost segregation analysis likely would be prompted for similar accounting or reporting requirements. Per the IRS, "In order to calculate depreciation for Federal income tax purposes, taxpayers must use the correct method and proper recovery period for each asset or property owned. Property, whether acquired or constructed, often consists of numerous asset types with different recovery periods. Thus, property is typically separated into individual components or asset groups having the same recovery periods and placed-in-service dates to properly compute depreciation. When the actual cost of each individual component is available, this is a rather simple procedure. However, when only lump-sum costs are available, cost estimating techniques may be required to 'segregate' or 'allocate' costs to individual components of property (e.g., land, land improvements, buildings, equipment, furniture and fixtures, etc.). This type of analysis is generally called a 'cost segregation study,' 'cost segregation analysis,' or 'cost allocation study.'"

If the joint venture investor determines that a cost segregation analysis is required, it likely will have to engage the report separately from the appraisal report ordered by the Senior Lender. This can add lead time to a transaction, so joint venture investors should take care to determine the necessity and the scope of the Senior Lender's appraisal report as early in the process as possible.

Phase I Environmental

Generally, there will be no change in requirements for an environmental assessment based on whether a transaction involves a joint venture investor or a preferred equity investor. As with preferred equity, a joint venture investor often can leverage the Senior Lender's report rather than having to engage its own.

Property Condition

As with the environmental report, many joint venture investors do not have different requirements for the property condition assessment as compared to preferred equity providers. This is another third-party report that many joint venture investors can leverage the Senior Lender's engagement.

Why Does This Matter?

Knowing what reports are likely to be required in a joint venture transaction will help sponsors with their timing as well as keeping costs down. If a sponsor knows what reports have been ordered and what components they will contain (which they may be able to find out from their Senior Lender), they can provide this information to the joint venture investor early in the diligence process. This allows time if the joint venture investor determines it needs additional reports or approaches to be ordered. It can help keep costs down as joint venture investors are less likely to need to pay for a "rush" report right at the end of diligence.

What It All Means

Third-party diligence largely remains the same whether a transaction involves a joint venture or preferred equity. The main difference revolves around valuation and reporting, so sponsors should keep in mind that additional reports or approaches may be required by a joint venture investor as compared to preferred equity.