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Plato and the Real Estate Joint Venture

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When the ancient Greek philosopher Plato struggled to define the elusive word "beauty," the definition he arrived at was "appropriateness to the goal in mind." And although nowhere in his writings does the sage deal with, say, allocation of tax losses or hedges against inflation, he could accurately be said to have described the ideal real estate joint venture agreement as well.

The right partners, brought together in an enterprise with the appropriate allocation of risks and rewards and costs and benefits, with a clear mutual understanding of the goals, time horizons, terms and conditions of continuity or termination and so forth, could constitute what Plato would have described as a beautiful joint venture.

The choice of "right partners" is properly the first point to be raised, especially in a Japanese/American context, since Japanese focus so often on "relationships," while Americans tend to focus on "transactions," and since lawyers and litigation are so much a part of the American business scene, whereas negotiators and consensus are so much a factor in Japanese thinking. The old Roman doctrine "caveat emptor" ("let the buyer beware") may make sense in a context of anonymous buyers and sellers, or in a setting in

which the parties never again expect to meet; but it is not necessarily appropriate in a culture that seeks long-term, harmonious dealings.

That Mr. Lee Iacocca could win public adulation (as well as tens of millions of dollars in his own pocket) by exchanging his leadership of his old Ford team for the leadership of an arch-rival, the Chrysler team, may be perplexing to Japanese observers; but it should serve to highlight the differing national attitudes toward loyalty, continuity and so forth. Similarly, Mr. Donald Trump's best-selling book, "The Art of the Deal," conveys clear impressions of how he comes out of a negotiation; a discussion of the goals or success of the other parties to the transaction would require another book. And it is important for Japanese to remember that the American legal system is adversarial rather than cooperative in spirit.

Impersonality (the so-called "arms length transaction") and short commercial memories are also characteristics in which national attitudes differ, and Japanese may perhaps find it perplexing to learn, for example, that American banks will continue to advance credit to borrowers who have turned back to them properties through foreclosure, who have canceled debts by bankruptcy, or who have used the "cram down" provisions of Chapter Twelve legal proceedings to diminish debt.

A prospective Japanese joint venturer may view such actions differently; and therefore a clear picture of the

character and history of a potential partner, as well as the technical or professional competence, should be explored. How litigious have they been in the past? How have they acted in adversity or under pressure? What is known about non-commercial activities and attitudes?

All are fair questions and all should be explored sooner rather than later. In a joint venture as in a marriage, the character of the partners may be as important as technical skills or legal arrangements.

Assuming, then, that the right partner has been selected, the appropriate arrangements must be designed; and the beauty of the joint venture vehicle is the remarkable flexibility it permits to all concerned. But flexibility in means is a virtue only if one knows clearly what he hopes to achieve.

In the last decade, virtually all of the most complex and sophisticated financial mechanisms available to the world of investment banking have been introduced into real estate transactions -- interest rate "swaps and caps," for example, or "securitization" -- and a truly bewildering array of alternatives are available; so it is important that participants have clear ideas about the goals they seek and the degrees of risk and exposure they are prepared to undertake. It has been said that business judgments often create a state of tension between "fear" and "greed," and each of us must decide for himself his own "threshold of pain."

Even in Plato's day, property ownership and use could be a complicated matter. Today, a broad spectrum of degree of risk is possible regarding property, ranging from the most conservative position, a senior land sale and leaseback, on through the progressively riskier senior mortgage; participating mortgage; free and clear equity holding; leveraged equity; ground leases; subordinated sandwich leases; and, finally, options.

Land speculation is usually riskier than development; development riskier than purchase of existing fully-leased buildings; "pioneering" development riskier than building on more expensive sites in established neighborhoods of unquestioned acceptability, and so on.

In each case, the successively greater potential risk is presumably balanced by a proportionately greater potential reward; but trade-offs exist and choices must be made.

Differing views of an acceptable time frame are also a factor to be considered; and, at the outset, each venturer should clearly understand the view of acceptable time horizons of the other. To state, as I can factually, that in its 60-year history our firm, Rose Associates, Inc., has never had a building venture foreclosed by its mortgagee, does not mean that in 60 years every structure we developed was necessarily worth more on opening day than it cost to build. It does mean that well-located, well-designed, well-built and well-managed buildings will, over time, do

well (and in periods of dramatic economic growth or high inflation, very well indeed).

Incidentally, although the oldest cliché in American real estate states that the three most important factors about a building are "location, location and location," in actual practice the key factors are really "location, financing and timing."

The last time I spoke at an Institutional Investor overseas conference was in London in December 1975; at that conference I pleaded with conference participants to buy prime U.S. properties then because economic conditions presented an historic opportunity that might not come again in our lifetimes; well, such opportunities may again be available before too long, but that is another story for another day.

To return to Plato's view of a real estate joint venture, however, I believe it fair to ask ourselves if a Japanese bank necessarily has the same goals as an insurance company; if a Japanese construction corporation shares the goals of a leasing company; if a real estate developer shares those of a trading company; and, when the Ministry of Finance and the tax laws permit, if a Japanese pension fund will share the goals of a rich Japanese private family, on the one hand, or of a syndication of small private investors, on the other.

Different goals for different investors require different investment vehicles.

Next, we must distinguish among the risks and rewards of real estate decisions and those of macro financial decisions and those of transactional dealings.

Our answers to real estate questions would be influenced by:

- a) Supply and demand factors for a given real estate product in a specific local market;
- b) Local political questions such as rent control; the possibility of dramatic increases in real estate taxes on change of ownership; or in New York, for example, something like the "Cuomo tax" on real estate gains; and
- c) Demographic changes; structural shifts in the economy; or geographic waxing and waning, as in Houston on the way down or the so-called "rust belt" on the way up.

The answers to macro financial questions would be influenced by:

- a) Forecasts of changes in international yen/dollar exchange rates;
- b) Varying inflation scenarios; or
- c) The relative volume of national supply of prime real estate versus the relative demand of potential purchasers of such property, which affects capitalization rates; and

- d) Federal tax laws involving possible double taxation of foreigners, withholding taxes for foreigners, and so forth.

The answers to transactional questions would be influenced by the goals of the specific Japanese investor, which usually are:

- a) Preservation of capital,
- b) Established minimum returns and
- c) Inflation protection; versus

the goals of the American development partner, which usually are:

- a) Maximum after-tax return;
- b) Operational freedom to run his business as he likes; and
- c) Additional financial liquidity to permit him to expand his development activities.

Given all of the above, Plato would undoubtedly have suggested not only the right partner but also the right advisor and the right attorney!

In conclusion, let me point out that Plato's most famous dialogue was entitled "The Symposium," which in the original Greek literally means "a coming together to drink."

With the drinks after our session, I would be happy, in the ensuing symposium, to answer any specific questions you may have.

Thank you.