CORPORATE REAL ESTATE STRATEGIES
FOR
STRUCTURING DEVELOPMENT JOINT VENTURES

by

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B.S., University of Utah
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KIP G. THOMPSON

Submitted to the Department of Architecture on August 15, 1986, in partial fulfillment of the requirements for the Degree of Master of Science in Real Estate Development at the Massachusetts Institute of Technology

ABSTRACT

This essay is an analysis and evaluation of decision criteria for corporate real estate executives to use in structuring joint ventures for developing corporate real estate. The joint venture arrangement being evaluated is one between a corporation (not in the real estate business) and a real estate developer. No previous experience with joint ventures is assumed.

Several corporate real estate managers and developers were interviewed to determine how corporate real estate decisions are made and to assess their experiences with joint ventures. A review of business and real estate literature was also conducted. The corporate experiences and literature were drawn from to construct the decision models and recommendations found herein.

The corporate characteristics most conducive to joint venture viability are described and used to construct profiles of the ideal corporate candidate. The risk and benefit tradeoffs of the joint venture approach, relative to other options, are used to establish ideas for maximizing benefits. Finally, the analysis focuses on guidelines for structuring and managing the joint venture. Some key provisions for the joint venture agreement are described.

Corporations are typically not equipped to handle the real estate development process alone. Joint ventures are recognized as appropriate vehicles for developing corporate real estate. The corporation can benefit by, reducing occupancy costs as well as maximizing value of corporate real estate assets while reducing the risks of development and ownership.

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ACKNOWLEDGEMENTS

Like most supposedly original works, this paper owes a great deal of its content to the experiences and ideas of persons other than the author. In the text, the author speaks with the voice of authority and experience, when in fact, the ideas were drawn from the experiences of others. To them the credit is due. First, I want to thank the many busy executives who were willing to share their experiences and ideas with me. In particular, I appreciate the efforts of Tom Steele, who unselfishly took time from his busy schedule to advise and help structure the direction of the study. He helped formulate my initial directions and gave constructive comments after reading bulky rough-drafts.

My thanks to Lynne Sagalyn, who demanded thoughtful analysis and clear focus. Classmates were particularly helpful in maintaining humor and support that smoothed the rough times. And finally, I dedicate this final project to my beautiful wife, Leesa for her love, patience, and endless support, during my research and writing.
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"Life is a constant process of deciding what we are going to do."
- Anonymous

This paper is an analysis and evaluation of decision criteria for corporate real estate executives to use in structuring joint ventures for developing corporate real estate. The joint venture arrangement being evaluated is one between a corporation (not in the real estate business) and a real estate developer. The discussion shows that a joint venture can be a viable and worthwhile consideration for maximizing the value of corporate assets and/or minimizing occupancy costs.

The intent is not to champion the joint venture approach as a panacea to every corporation's real estate strategy. Instead the paper provides a survey of issues encountered by corporate real estate managers in evaluating real estate options and suggests an approach for maximizing the potential of a joint venture alternative. The analysis focuses on issues to consider in assessing whether joint ventures are an appropriate vehicle for developing real estate from the corporate context. The paper discusses characteristics of a suitable corporate joint venture
Joint ventures are not new to the business world. They are regaining attention as a means for sharpening competitive strategies in new product development and other arenas. Real estate development joint ventures, like the corporate cooperative ventures being discussed in business journals and texts are vehicles that enable firms to undertake activities that they could not (or should not) undertake alone. Large corporations use the approach to attract capabilities and entrepreneurial energies that their own firms lack.

Large corporations such as Xerox, IBM and AT&T have begun to use joint venture alternatives, with some frequency, to develop corporate real estate. The idea to study joint ventures was sparked by the realization that perhaps each entity (the developer and the corporation) had something unique that could lead to synergistic outcomes. A developer possesses experience, knowledge, ideas, marketing skills and managerial capabilities, but may lack financial resources, land, or a tenant. The corporation in this scenario has some combination of land, cash, credit or space needs, but wants lower occupancy costs. Since some of the large corporations have blazed the trail, others are
beginning to follow suit or at least consider joint ventures as a viable option to their real estate strategy.

A. THEESIS RESEARCH METHODOLOGY

The information gathered for this analysis came from a survey of both trade and general business literature. In addition, I interviewed developers and corporate real estate managers from several of the largest corporations and development firms in the country. Insight and direction also came from advisors and consultants close to the field. The interview process brought an insider's perspective and focus on the primary issues and concerns of parties to such mutual ventures.

The scope of the corporate-research was oriented towards large, well-known, corporations most with national (if not international) presence. As it turned out, many were in a growth or stable stage of their industry. Some of those interviewed have no interest in, nor would they consider joint-venturing real estate development projects with developers. Those with no interest either had in-house capabilities, which enable them to monitor development projects of their own; or no interest in building at all. Some could see little justification for joint venturing at a time when developer's are offering so many short-term concessions on leased property are so abundant in the current saturated markets. Others find joint ventures advantageous and are in the midst of several joint venture
projects at present. Virtually, all firms interviewed had at least considered joint ventures. The curiosity is strong since many have recently received proposals from developers for joint venture.

For various reasons, many of those interviewed requested anonymity which I intend to respect for all. The information gathered was, therefore, used to generate ideas and a perspective from which others can benefit. Any direct references in this text came either from literature or are matters of general knowledge. The study intentionally excluded financial institutions such as banks, pension funds, insurance companies or syndications - those who are already in real estate oriented businesses.

A search of the literature on the subject revealed a mix of books and articles on asset management (typically written by corporate real estate managers) which of late are calling for a profit oriented strategy towards real estate assets. Others spoke of the "war stories" of corporations who valiantly plunged into the real estate business in the 1960's and 1970's and came out badly scarred and beaten. The evidence is clear that much of the real estate held by corporate-America is under-utilized or misunderstood. It certainly represents a potentially phenomenal dollar value estimated at $1.4 trillion dollars.

Corporate-America owns or controls billions of dollars of real estate assets. This paper is not about asset
management; yet, to discuss corporate real estate alternatives is to discuss the need for asset management. One real estate asset management approach used by some corporations is a joint venture arrangement with an experienced developer. This paper is intended to highlight and analyze the nuances of this approach based on interviews with developers and corporations.

B. THESIS STRUCTURE

The intended audience for this paper is corporate real estate managers. Recognizing that such a title could apply to a wide array of job descriptions, I have narrowed the target audience to those managers within large organizations with an active real estate entity. Little familiarity with development or corporate real estate objectives is assumed. The first chapter provides an overview of corporate experience in, and attitudes towards, the real estate industry in general; the focus shifts towards management of real estate used by the corporation. The chapter concludes by discussing the range of alternatives available to corporations and how each might affect corporate objectives.

Chapter two focuses on strategic methods for exploring options in real estate. Corporate objectives are suggested as the starting point for decision-making. The joint venture alternative is considered in light of corporate characteristics that might impact the decision to joint venture. An analytical framework for evaluating the qualitative and quantitative issues is presented and the
chapter ends with a discussion of the ingredients necessary for a joint venture strategy to work.

The remainder of the paper focuses solely on joint ventures. Profiles of three different joint venture candidates provide the basis of discussion. Chapter three lists and describes the pros and cons of a joint venture strategy in light of the proposed profiles.

Chapter four outlines the internal and external constraints for joint venture organization. The joint venture is examined from the eyes of the developer-partner and tips are given for selecting the "ideal" mate for the venture. The discussion also looks at some negotiation suggestions for optimizing the value of the venture for the corporation.

The final chapter offers some suggested concerns to be covered in the joint venture agreement. It is intended to give an overview of the critical issues that need to be raised as the parties prepare to bind their working relationships. The conclusion offers some final commentary and lists some general conclusions from the research.

C. CORPORATE REAL ESTATE: PAYDIRT OR FOOLSGOLD?

In recent years real estate journals and periodicals have devoted increasing attention to the need for improved management of corporate real estate. These articles frequently admonish corporate real estate managers to "tap the hidden veins" of value in corporate real estate assets
and usage.

Asset management is seen by some as the "last great frontier for the American corporation in its quest for internationally competitive strength." The literature would suggest that the value lies not only in under-utilized corporate-owned facilities, but also in the corporate signature on a corporate lease-hold. Earlier articles went so far as to suggest that corporations use their resources and managerial skills to enter real estate as a separate line of business and means of diversification.

The message is not new - it was parlayed with even greater vigor in the 1960's. One article in the Harvard Business Review (July/August 1967) entitled "Real Estate as a Corporate Investment" was widely circulated in the executive offices of many corporations. Corporations were concerned about the future of earnings per share and this idea of tapping into the profit potential of real estate offered hope.

The result was that many of the country's largest corporations jumped into real estate development as a separate line of business during the 1960's and 1970's. A great fever seemed to sweep corporate America into a new-found profit source. For a brief period, corporate chief executives were anticipating great profits from the newly discovered real estate industry. Business literature and Wall Street brokerage house market letters during that
period gave the impression that corporations were about to "make it big" in real estate. Security analysts even gave strong recommendations to those companies with real estate equities. 8

The results in most cases were disastrous. The hope that real estate offered was dashed quickly as the failures brought about a rapid exodus. The question remains, whether real estate is a source of value and profit to corporate-America or a fixed asset to be maintained and put up with as a necessary nuisance to the main-line objectives? Should corporations (other than experienced developers) be in the real estate business? If not, can they "profit" from the real estate that they own or use?

The answer lies first in understanding the past and the implications on the future. Will future corporate attempts at developing real estate be met with the same perils that impacted so many in the past. An understanding of the past is sought by reflecting upon, 1) corporate motivations for entering real estate, 2) the type and extent of corporate involvement, 3) the results, 4) an analysis of the results.

1. Motivations

The motivations for corporate entry into real estate in the 1960's were diverse. They included such stated aspirations as:

- Diversification,
- Compensating for downturns in business cycles,
- Improving profits in the long run,
- Hedging inflation risks,
Harboring large cash reservoirs,
Sheltering accumulated earnings from taxation,
Supporting social objectives for redevelopment,
A means of using surplus corporate land,
A means of marketing company products,
Testing new technological systems.

Many pursued real estate development under the recommendation of competent consultants such as Arthur D. Little Inc. But few corporations did anything substantial to study project feasibility. In spite of the claims and stated objectives for corporate selection of real estate as a line of business or a means of capturing value, one former president stated, "up until about 1972 it was fashionable for corporations to get into real estate; and since 1972, it has been fashionable to get out".9

2. Extent of Corporate Involvement

It is difficult to generalize about which type of corporation got into which aspects of the business. Their experiences and depth of involvement varied. Many corporations pursued land development, wherein large parcels of raw land, or land with minimal site improvements would be purchased and up-graded for subdivisions, shopping centers, office parks, industrial parks or recreation. Actual development was conducted either by the corporations themselves or by third-party builders. Some of the big corporate land developers included Boise Cascade, Dart Industries, ITT, McCulloch Oil and Kaiser Aluminum.

Several corporations chose to develop residential real estate. They cited the shortage of housing, pent-up demand,
growing population, as well as corporate management and production skills as incentives for that move. Corporations such as CBS, Loews, Olin, American Standard, Phillip Morris, Weyerhauser, Avco, ITT, and Johns Manville were among the largest players in the housing business. The course most of them pursued was to get into residential development through acquisition of one or several builders or developers already in the business. By some, the residential development business was seen as an investment of great promise that would grow, perhaps faster than their primary business.

The impetus for other corporate entries into the real estate business came from a review of their own real estate holdings. Many such holdings were non-productive assets that had potential of much higher and better uses. In addition, much of the land was reported at book value while market values were several times greater. The list of corporations in this category is endless. Among those who were reviewing their land inventories were some like Rockwell International, U.S. Steel, Sun Oil, Hercules, Lockheed, Stauffer Chemical, Transamerica and Scott Paper. While some sold land outright, others chose to develop the surplus assets on their own through company owned subsidiaries or with a partner.

A few corporations became involved in development or development ventures only with the intent of making a
corporate statement or furthering their own image. Still others such as General Electric, Westinghouse and Walt Disney viewed land development as an opportunity to create an urban laboratory for testing their own new products and systems. 10

3. The results:

If the score had been kept on corporate ventures into real estate in the 1960's it would be seriously slanted against the corporations. In the earlier 1970's heavy losses were incurred and reflected in corporate earnings. A few of the most noted examples are described herein:

- Boise Cascade was certainly one of the big-time losers; with write-offs of $78 million in 1971 and another $150 million for real estate losses in 1972.

- The Penn Central experience demonstrates how leveraging can backfire on a real estate investment strategy. Pennsylvania Railroad (Penn Central) acquired Great Southwest Corporation who became very active in acquiring and selling real estate. Net income on the parent company books rose rapidly. However, receivables were consistently low since expansion was achieved by leveraging. As interest rates rose the subsidiary badly overextended. Debt service could not be covered out of cash flows. Management was forced to restructure.

- Westinghouse was clobbered particularly hard in government subsidized housing. They were plagued by environmentalist legislation and protests from city groups in planned residential communities. Their luck was better in the hands of management team it acquired. Westinghouse's failures have been largely attributed to inexperience and internal management problems.

- American Standard terminated its activities in land and housing development in 1974. Its experiences had been plagued with large losses in mobile home, recreational and housing developments.
4. Analysis of results: Why corporations failed?

An analysis of the past failures of corporate development of real estate reveals some interesting patterns. The annual reports and responses to inquisitive shareholders prompted executives to point to such exogenous forces as: the economic recession, rapidly rising interest rates, the environmentalist movement and governmental red-tape. While it is impossible to discern the relative weight of such factors there were other internal forces fueling the failures as well.

Perhaps the largest contributing factor to the demise of corporate real estate activity was the lack of familiarity with the real estate industry. A review of the factors (see Table 1-A) contributing to failures in corporate real estate may help formulate a more proactive strategy.
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<td>WHY CORPORATIONS FAILED</td>
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<tr>
<td>o Inexperience in the development business,</td>
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<td>o Early successes bolstered confidences and led executives to take greater risks,</td>
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<td>o Misunderstanding of market and financial characteristics of real estate,</td>
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<td>o Lack of knowledge of real estate markets and operating techniques,</td>
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<td>o Excessive use of leverage (with unsustainable relationships to cash flow),</td>
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<td>o Conflict between real estate profits and need for booked earnings,</td>
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<td>o Changes in accounting guidelines (which affected reported earnings),</td>
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<td>o Overpayment for acquisitions of development firms,</td>
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<td>o Lack (or laxity) of management controls,</td>
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<td>o Conflict with development partners or subsidiaries,</td>
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<td>o Internal communication problems,</td>
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<td>o Inflexible corporate management styles,</td>
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<td>o Acquisition mania (acquiring unrelated entities without careful planning),</td>
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<td>o Lack of goal definition,</td>
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<td>o Poor management controls,</td>
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<tr>
<td>o Failure to &quot;reach&quot; the appropriate market,</td>
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<td>o Inopportune timing,</td>
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<tr>
<td>o Inadequate planning,</td>
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<tr>
<td>o Acquisition of unproven or unseasoned development firms,</td>
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<tr>
<td>o Failure to investigate the special economic and operating characteristics of real estate business,</td>
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<td>o Inexperienced corporate personnel acting as liaisons between parent and subsidiary,</td>
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<tr>
<td>o Belief that industrial and management skills are transferrable to development business,</td>
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<td>o Slow moving decision processes.</td>
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The failures took place predominantly within corporations who were attempting to enter the real estate industry as a separate business. They lacked the experience as well as the characteristics to make it work. It has been
said that "those who can't remember the past are condemned to repeat it".\textsuperscript{12} Therefore, the remainder of the discussion is intended to take the historic failures as a lesson in guiding the future of corporate involvement in real estate. The evidence is clear that corporations lack the entrepreneurial management capabilities to manage the development process. Many would agree that they also lack the interest. Real estate is not their business.

The message is eminently clear that solo ventures into real estate development by corporations in totally different and distinct lines of business are unwise. Evidence indicates that corporations are not anxious to repeat history. Yet, in some sense corporations are in the real estate business.

The real estate used by corporations in their primary business is the source of corporate involvement in the real estate business. One real estate executive proclaimed "anytime you have over 3 million square feet, you are in the real estate business". Most corporate executives see the untapped potential. The key to capturing the value is to make real estate a more vital part of the corporate strategy.\textsuperscript{13}

A study conducted by Harvard Real Estate, Inc., a subsidiary of Harvard University, shows that "proper management of real estate assets by any company can make a significant, positive short-term as well as long-term
impact. The study estimated that American companies' real estate typically accounts for at least 25% of their total assets and is worth an aggregate between $700 billion and $1.4 trillion - a sum equal to, or greater than the nation's pension funds." The conclusion of the study is that given the aggregate value of real estate within their domain, corporate executives have an obligation to put their real estate assets to their highest and best use. The authors conclude that "every corporation should review and adjust its real estate policies to reconcile operating objectives with contemporary real estate values and opportunities." 14

The value lies within corporate real estate, whether leased, owned or developed; yet only 40% of American companies clearly and consistently evaluate the performance of their real estate."15 Most treat it as a facility or an overhead item like stationery and paper clips. Some large corporations, such as Rockwell International, IBM, Xerox, and AT&T have discovered the profit potential in strategically managing corporate real estate. The source of great value is there. It is up to corporate executives to tap that source in a responsible and advantageous way that does not detract from its principal business. Corporate managers can begin to tap the value by evaluating corporate real estate usage and selecting strategies that maximize value.
One of the most crucial factors that led to the demise of past attempts at corporate development was lack of internal experience. Many people feel secure in their experience in real estate development when they own a house or have participated in real estate decisions. The truth is that the development process is complex and requires a lot of entrepreneurial capabilities and understanding of the market that are not existent in many corporations. History has shown that for most corporations it is not only imprudent, but irresponsible, to attempt development on their own without sufficient experience.

D. CONSIDERING THE RANGE OF ALTERNATIVES:

The options available to corporations for managing their real estate assets are endless; examples can be found to support almost any approach. This section outlines the range of alternatives that are available. An exhaustive exploration of the many options is beyond the scope of this review. The continuum being considered ranges from speculative development, on the one extreme, to being a gross lease tenant on the other (see Table 1-B). It is assumed that all corporate real estate activity will can be placed somewhere along that continuum. In reality, the options are infinite and the simplification used here is not intended to indicate that options are confined to those listed.
How does a corporate user make the decision? In the past the decision seemed fairly clear. A simple economic buy/lease evaluation was usually conducted. Within the financial constraints and some qualitative criteria the decision was made. It is no longer quite so simple. The following discussion explores some of the major advantages and disadvantages of the bipolar ends of the spectrum.

1. Reasons for developing or owning corporate real estate:

   Perhaps the most compelling motivation for corporations to consider owning the space they utilize is the control it affords over design, quality, construction and management. Ownership allows more control over occupancy costs and can be a source of profit. Often, the motive for ownership is enhancement of corporate image or simply to be a good corporate citizen in a community. Sometimes becoming your own landlord is motivation enough for corporate executives. Some may be motivated by tax benefits.
Large corporations with name-recognition and blue-chip credit bring tremendous value to a real estate development. Their presence in a development brings additional value to surrounding building in many cases - a phenomenon which economists refer to as "externalities". These benefits accrue to the building owner in the form of increased demand and rents. A great deal of value is also added through the land development, approvals, design and construction processes. Ownership allows a corporation to reap the benefit of such added value.

2. Some key disadvantages of developing or owning corporate real estate:

While technically a large corporation can exert significant control via covenants in the lease contract, these rights are not always enforceable. From a practical standpoint the enforcement of such rights may often require legal recourse which can be costly, disruptive and time consuming.

The risk inherent to real estate development is substantial. To the extent that such risks can detract from the main line of business, corporations will tend to avoid ownership. Inexperience in the industry multiplies the market, financial and operations risks.

Real estate development is an unknown business to most large corporations. The managerial characteristics needed to orchestrate a successful development project tend to not
exist within a large corporate framework. Unfamiliarity with the business is one of the factors that led to most of the problems by those who ventured into development in the 1960's and 1970's. Some corporations are not interested in the managerial difficulties attendant to ownership.

Compared to a lease transaction, ownership of real estate typically involves a higher up-front cost of time and capital. The development of a building requires investment in feasibility studies, financial analysis, market analysis, construction and design management and property and leasing management.

Dedicated and skilled real estate management capabilities must be in place to ensure success in any real estate investment venture. To be effective, the management team must have sufficient authority, autonomy and accountability to minimize delays and bureaucratic complexities and to avoid conflicts with operating business entities.

3. Reasons to consider leasing:

Corporations in a mode of high growth need maximum flexibility in changing and reconfiguring office capacity. For the startup, high-growth corporation unsure of it's future and sorely in need of cash, a lease offers needed flexibility, the choice is simple. Any available cash, time and energy will be funneled into the primary line of business. Short term leaseholds do not tie up large sums of
capital. Marketing offices of growing corporations may be leased for the same reasons.

The administrative efforts required for initiating and closing on lease contracts are relatively simple. Operations managers are likely to have more autonomy on making a lease decision than say a long-term purchase commitment. The time required for securing and the effort to gain approvals from within the corporate structure tend to be easier.

Terms of leasehold interests may correlate more readily to the corporate short-term planning horizon. They do not tie up large blocks of capital that could be used more productively in the product development or marketing process. Furthermore, a lease does not raise the debt to equity ratio of the company. However, the Financial Accounting Standard Boards requirement (FASB 13) that "capital" leases be shown as additional debt on the balance sheet makes the difference between leasehold and ownership less significant in some cases.16

Approval policies employed by many of the corporations interviewed would indicate a propensity or incentive for managers to utilize short term leases. The policy, whether stated or not, comes from approved expenditure limits given to managers at certain levels.

4. Some key disadvantages to leasing:

Rapid escalation of office rental rates can cause
occupancy costs to grow geometrically. One study found that occupancy costs, as a percentage of revenues, doubled from 2% to 4%. They are projected to reach 7% by the year 2000. Such price escalation can have a significant effect on corporate earnings.¹⁷

Not only are costs rising over time, but leaseholds typically offer little opportunity to capture long-term appreciation values of real estate. Large corporations may be able to gain significant contractual rights in their lease agreements, enforcement of such rights is not always realistic. The tenant has little control over design, management procedures, or neighboring uses.

Somewhere in-between the development and leasing options lies the joint venture alternative. A joint venture can be structured to approximate or to differentiate from either extreme. It can, in fact, be structured as a genuine hybrid which allows a corporation to capture the advantages it seeks in both extremes and to share the disadvantages. However, with the developer a joint venture brings new risks from the introduction of a partner. Not all disadvantages dissipate, but properly structured it can be a means for gaining some of the benefits of real estate development and asset management in concert with an experienced developer who also shares the risks.
"...Much of the wretchedly poor performance of large numbers of corporate real estate developers has been a function of poor management and poor definition of objectives."\footnote{1}

Where do corporations "fit" along the continuum of options in real estate? Is the fate of corporate opportunity in real estate development sealed by the dismal performance of the past? It is possible that the national economic recession brought about a historic anomaly, in the failures that plagued corporate developers, that will not be repeated. But the evidence seems to indicate that corporations just could not handle real estate operations. The history of corporate diversification into real estate is sufficient to warrant skepticism about the wisdom of solo corporate attempts at developing real estate.

Corporate executives were inexperienced when going into real estate. They were uncomfortable while in it, and the requisite characteristics for success in the industry were never quite attained.\footnote{2} Real estate development and the various production and service industries are just different enough that the chances for success in both arenas simultaneously, is unlikely. It is safe to say that few
large corporations will venture into development as a line of business. Fewer than two dozen of the largest American firms are there now. Those who are there such as Gulf, Mobil, and Weyerhauser, have weathered the storm and appear likely to stay, but the new entrants will be few.

While the picture looks less than enticing for full-scale entrance into development, opportunities still abound. Corporations are in the real estate business by virtue of the amount of space they own and occupy. The value of corporate real estate assets can and should be exploited. History would indicate that corporations are better off concentrating their efforts on what they do best - their main line of business. Within that guise the establishment of a corporate real estate strategy begins with an understanding of the overall corporate objectives and how they apply strategically to the operating and marketing units. The value for corporations lies within the needs and strategies of these units. The real estate entity must understand the strategic direction of the corporation well enough to translate the operating concerns into long-range facilities plans. The intent of this chapter is to explore how a corporate real estate manager can effectively utilize and profit from the real estate assets and needs of the corporation.

A. FINDING THE "HIDDEN VALUE" IN CORPORATE REAL ESTATE

The consensus among academics and practitioners alike is that corporate real estate is under-utilized and that it
is, in fact, a great source of value for corporations.\textsuperscript{4} One study discovered that barely 20% of American corporations manage their real estate for profit. Only 40% clearly and consistently evaluate the performance of their real estate.\textsuperscript{5} Value cannot even be recognized, much less extracted, without some performance-driven system of evaluation.

In the capital budgeting process, corporate real estate (or facilities) oftimes gets relegated to the lowest of priorities. Demands on the capital budget are always higher than a corporation can afford. Management is not anxious (nor should they be expected to be) to cut demands "needed" for "operations-oriented" capital items, so real estate expenditures or investments often get cut until the need for space is urgent (as one manager put it, "until people are hanging out the windows").\textsuperscript{6} The only "big ticket" item left to cut is real estate - so it gets cut. The process described, ignores the fact that real estate may have inherent qualities that can add to, rather than detract from the operations objectives.

Finding the "hidden value" in corporation real estate requires a re-evaluation of traditional response-oriented facilities operation (also characterized as "you call, we haul") to a strategic, goals-oriented management. A strategic planning orientation will allow the corporate real estate manager to capture the value unique to real estate by proactive rather than reactive management. What
differentiates real estate from other capital assets such that it may possess "hidden value"? Real estate assets typically:

1. come in large denominations,
2. appreciate in value over time (while accounting treatment depreciates,
3. can be leveraged,
4. provide tax benefits,
5. provide a long-term source of high returns, and
6. are undervalued on corporate books.

Most real property assets are carried on the books at historical cost. In many cases the market value is much greater, due to appreciation that has not been accurately reflected on the books. This is so, in spite of the Financial Accounting Board's Standard 33 (FASB 33) which calls for adjustments to book values so that net assets are stated in terms of constant dollars and current costs - a practice which is followed in footnotes, but not in the main financial statements. 7

Therefore, a corporation with properties that are worth more than book value may have a great amount of unused secured borrowing capacity lying dormant. In addition, the real estate assets that are not actively managed may be under-utilized and, therefore, a potential drain on resources. As an example, Lockheed Corporation has significant real estate holdings adjacent to the Burbank Airport that are severely under-utilized given the current value of the property. A proactive strategy for the company could include an evaluation of the current use to the
potential highest and best use. The land could be rezoned and parcelled off or developed at a tremendous profit to the corporation. A reactive approach might necessitate a quick sale at distressed prices at some point when the corporation is in desperate need of cash. It is clear that proactive management stands a greater chance of enhancing profitability. It also requires a corporate commitment to active management of real estate assets.

Corporate users of real estate have provided a substantial portion of the profit that developers have tapped from real estate's unique characteristics. Major corporations, being the most significant users of America's office and industrial space, already direct the commercial real estate market in terms of what is built and where it is located. The assets of today's corporations can be better utilized if they will but recognize the untapped profit potential within the real estate portfolio and space utilization. Robert K. Brown, Director of Real Estate for Rockwell International Corporation stated:

"no mission of the corporate entity is better understood or more critically judged than profit performance. Hence, the real estate unit should also be judged on the basis of its contribution to profit performance, and it should be directly accountable to top management on the same basis as other operating units."

The key to hidden value from a corporate perspective is profit (which includes reduction of occupancy cost). To find acceptance within boardrooms, any real estate strategy should be oriented towards enhancing that measure of
corporate well-being. To find the "hidden value" in real estate a corporation must first be interested enough to set up strategically oriented evaluation system, a performance measure and a line of accountability. Otherwise, real estate will continue to be under-utilized and a potential drain on corporate earnings.

Experience has generally shown that corporations who "stick to the business they know best" stand a better chance of success. While that is an argument for maintaining a focus on the primary line of business, it does not substantiate any right to neglect, or refusal to enhance and capture the value in corporate assets.

B. DETERMINING A CORPORATE REAL ESTATE STRATEGY

A realization that value lies within the corporate real estate asset coffers requires a plan for extracting it. The following strategy is a tool for assessing and capturing that value. It represents a compilation of strategies suggested by corporate real estate managers and by literature on facilities management and real estate investment strategy. 10

Determining a corporate real estate strategy involves a series of steps to be applied corporate-wide on a project-by-project basis as outlined in Table 2A. The following discussion describes the process.
TABLE 2-A

DETERMINING A CORPORATE REAL ESTATE STRATEGY

I. NEEDS ANALYSIS PROGRAM

1. Assess Corporate Objectives and Strategies
   - Financial objectives
   - Operational objectives
   - Basic screening criteria

2. Evaluate Current Status of Real Estate Portfolio
   - Identify properties
   - Assess efficiencies
   - Isolate surplus properties

3. Forecast Capacity and Facility Needs Requirements
   - Identify operations needs
   - Budget/financial constraints
   - Time horizons and lead times

II. EVALUATION OF ALTERNATIVES

1. Generate Alternatives and Standards
   - Collect location data
   - Build/joint venture/lease options
   - Use requirements

2. Establish Decision Making Criteria
   - Financing decision
   - Critical analysis (NPV, IRR, Occupancy Cost)
   - Qualitative factors

3. Analyze Alternatives
   - Weight risk/reward tradeoffs
   - Cost/benefit analysis
   - Efficient frontier - portfolio analysis

III. JOINT VENTURE STRATEGY AND AGREEMENT PROCESS

1. Select Option
   - Operating plan
   - Define expectations
   - Gather information

2. Conduct Detailed Financial & Qualitative Analyses
   - Market/marketability analysis
   - Structure financial requirements
   - Set corporate parameters

3. Partner Search and Selection
   - Requests for proposal
   - Screening
   - Negotiation and agreement process

IV. MANAGING THE JOINT VENTURE BUSINESS

1. Manage the Development Process
   - Degree of control
   - Risk containment
   - Accountability

2. Conducting the Business
   - Dealing with conflicts
   - Information exchange
   - Adapting to changing needs

3. Meeting Corporate Goals
   - Expectations of user group
   - Assertive support function
   - Performance measures
I. NEEDS ANALYSIS PROGRAM

The needs analysis program represents the ongoing day-to-day function of the real estate group within the corporation. It is as much political as it is technical. Each operating entity within the corporation has its own standards and interests—many of which may conflict with the real estate group and its mandate.

1. Assess Corporate Objectives and Strategies

The first task is to probe and define the short- and long-term corporate objectives and the intended strategies for achieving them. Before a decision can be made to attempt a joint venture development, the corporate executive needs to assess and clearly understand the corporation's primary goals.

From a list of corporate financial and operational objectives and constraints, the corporate manager can establish initial screening criteria for analyzing proposals or alternatives for leasing, buying, or developing real estate. These criteria are applied at different stages of the evaluation process to distinguish options that are best for the corporation's goals and policies.

2. Evaluate Current Status of Real Estate Portfolio

This step is best performed on a continuous basis. It involves setting up an inventory system to track properties in terms of costs, market value, income, and expenses. The inventory should be an up-to-date record of all properties
owned and leased; by location and type of use. Other pertinent information includes the description, age, capital improvements, needs, and historical performance of each property.

3. Forecast Capacity and Facility Needs Requirements

The operations groups will be implementing their respective strategies for achieving corporate objectives and will have expanding or contracting space needs. The corporate real estate function is to accurately assess those facilities needs and be prepared to fill them when needed. This requires scrutiny of the budget and financial constraints on each operations group, relative to its plans.

II. EVALUATION OF ALTERNATIVES

The process of evaluating available alternatives increases the probability of making decisions that optimize space utilization and profit maximization objectives. Generating alternatives is a creative, yet, intuitive process that becomes more efficient as experience is gained. Creativity is to be encouraged in this stage since well-reasoned, creative alternatives often provide new ways of maximizing gain.

1. Generate Alternatives and Standards

Once an assessment of the corporate objectives, policies and requirements has been made, the real estate issues can be brought into perspective. The assessment procedures may seem second-nature, but their importance is accentuated by a
perusal of the many failures experienced by corporations who embarked into the development without adequate planning.

The next step is to bring the developable asset into the analytical process. Will its development in some way contribute to the main line of business? Will it reduce the cost of occupancy? A question that is not so easy to answer at first, but one which must be continually revisited throughout the process.

The process may start with location preference and requirements data from the operating group. The next step considers the options as financing alternatives. The alternatives considered can fall anywhere along the build/joint venture/lease continuum or beyond. One large corporation has been recently evaluating master-lease alternatives that capitalize on the desperate quest for tenants in soft real estate markets such as Houston or Denver.

In the initial "brainstorming" process some standards must be set to disqualify alternative proposals that are clearly beyond the scope of the corporate interests. For example, IBM will only consider markets where they have a critical mass of employees and space needs that they expect to maintain for the foreseeable future. Examples of other standards might include design requirements, rate of return criteria, stage of development, size of facility and developer characteristics.
Next, potential partners might be asked to submit proposals on a standard form which defines corporate criteria and explicitly states the assumptions. The advantage of the form proposal is that it facilitates the screening process. The disadvantage is that it may skew the results and stifle creativity from the developers. It may also leave the corporate decision-making blindsighted to important issues that were overlooked.

The discussions in this text imply that the corporation is the initiator of the project. In fact, many projects are spawned by uninvited proposals. It may help to have a system of initial tests to determine whether the unsolicited proposals warrant further scrutiny. At least, one corporation bases initial review criteria on predetermined location and timing factors.

2. Establish Decision Making Criteria

The alternatives generating process is essentially one of making the financing decision. The decision making criteria used by the corporation in assessing investment options can be one of the standards used. Alternatives include analysis on the basis of NPV, IRR, or Occupancy Cost.

One experienced real estate manager stated that while financial analysis may serve as the screening device, most often the alternative selected is on the basis of qualitative issues such as; location, timing, term or need
and other macro political or socioeconomic issues.

3. Analyze Alternatives

The critical analysis criteria (ie. NPV, IRR or Occupancy Cost) should be applied in an analysis of each alternative relative to the others. This process will require generations of first cut pro forma figures and risk/reward tradeoffs. Many subjective factors impact the analytical process.

It may help at this point to apply traditional portfolio management techniques to weigh risk/reward influences and establish whether each alternative falls along the efficient frontier of expectations. Cost/benefit analysis will help apply the more important qualitative issues.

The financial feasibility exercise should begin with a one year cash flow projection that considers the corporation's return/risk requirements as well as the lender's loan underwriting requirements. Alternatives that do not meet the corporate return criteria or that fail to meet qualitative standards should be eliminated at this point.

One large corporation had qualitative standards that exclude any alternatives less than 50,000 square feet. They also insist on getting in at the predevelopment stage of any project (lease/buy/or joint venture) so they could impact design criteria and so they could capture the value-added
where ownership was involved. Often, the qualitative standards may consist of preferences of the officers of the corporation.

III. JOINT VENTURE STRATEGY AND AGREEMENT PROCESS

To this point a lot of attention has been given to information gathering and sorting in order to generate and evaluate the range of available alternatives. At this juncture the decision to pursue a buy/joint venture or lease alternative is made. The remainder of the model assumes that the previous financial and qualitative analyses led to selection of the joint venture alternative. The analysis and decision are hardly complete. Much more detailed and focused analysis is conducted through this next stage.

1. Select Option

The tentative decision has been made to pursue a joint venture. The next step involves a thorough definition of corporate expectations in order to devise an operating plan. Key assumptions are brought into the analysis process so the information gathered must be more precise: "What equity investments will be made?", "What are the precise corporate locational and space requirements?", "What are the design and space standards?" These are all examples of the questions that will come up at this point. Operating plans should be drawn up and circulated to key people within the organization to ensure that the inputs are according to expectations.
2. Conduct Detailed Financial & Qualitative Analysis

The corporation combines all information gathered and data generated from previous steps to conduct discounted cash flow analysis of the type of property desired. Financial requirements are clearly specified and investigation is made into potential marketability of anticipated speculative space. While separated here in terms of function, this step is actually being conducted in concert with the partner search and selection process. Key data must come from proposals submitted by the potential partners. The issues discussed are on the simplified assumption that several proposals have been solicited and can be evaluated simultaneously. In the more likely scenario where the initiative comes from the developer, a shortened pre-screening process will be helpful.

3. Partner Search and Selection

The basic parameters of the expected project are issued to developers and proposals requested. The first milestone is to gain a meeting of the minds with the prospective partner. Many qualitative factors are applied in selecting the developer. The negotiations process is underway and screening eliminates those proposals that do not fit the corporate parameters. The entire partner selection and agreement process gets underway with the accepted suitor. Chapter four discusses more detailed partner selection criteria.
IV. MANAGING THE JOINT VENTURE BUSINESS

The establishment of a joint venture business entity, the agreement and development plan are significant steps that are not covered within this model. However, the marriage and its consummation are not to be considered lightly or insignificant, so they are discussed elsewhere in the text. (Chapters four and five covers these issues). Once the venture is formed, it takes on a life of its own, but still requires ongoing management.

1. Manage the Development Process

The development process is laden with risks and complexities. The means of managing the process should be laid out in detail in the partnership and development agreement. The effect and influence that the corporation will bring to bear on the process must be spelled out well in advance. Control will be partly a function of the corporation's status within the partnership - whether general or limited partner. However, a limited partner can effectively define enough control measures through the joint venture agreement and the lease contract to make the difference almost indistinguishable. The partners must agree on how the risk is to be contained and who is accountable for what. Few corporations want the project debt to be recourse and may require guarantees from the developer for debt as well as construction-cost and time parameters.
2. Conducting the Business
   In most cases the developer will insist on being and should be the operating partner. Systems must be put into place for dealing with conflict and changing needs. It must be remembered that the two partners are typically coming to this transaction with many mutually exclusive expectations. For instance, the developer typically wants higher cash flow for better financing terms, and residual value. The corporate user group wants reduced occupancy costs. What happens if the corporate partner wants to cash out or finance out of the project to funnel cash reserves to the parent when the developer has other expectations? These issues must be resolved in advance.

3. Meeting Corporate Goals
   The corporate real estate subsidiary or department should never forget that it is nothing more than a support group to the primary business seeking to maximize the value of corporate assets. It can be profitable but not at the direct expense of the parent. This last step returns the process to the beginning assessment of corporate goals and argues for the implementation of performance measures that enable the real estate function to assess its contribution.

   What performance measures should be used by a corporate real estate entity? The two most important goals are reduction of occupancy cost and profitability. Performance milestones such as delivery time, occupancy cost per employee, or cost of real estate to corporate assets can be employed. The impact of real estate activities on the
balance-sheet is important and key reporting standards can be implemented to measure it. Some suggested measures include:

- percent of real estate assets/total assets
- percent of real estate assets/shareholders equity
- property sales contribution to annual earnings (and earnings per share)
- percent of corporate debt in real estate assets
- disposition values of surplus properties
- performance relative to annual objectives

The particular measures will differ by company, but performance measurement could be initially based on the status evaluation of corporate real estate recommended in Table 2-A. Reductions in occupancy costs of current space and additions to profit or net-worth in the utilization of surplus space are both key measures. Management efforts that don't contribute to reduction in occupancy costs or profitability should be abandoned. Since real estate management is a support function within the corporation, the performance measures should also reflect the manner which support is provided. Performance measures are complicated by the conflicting objectives between the real estate groups and the operating groups within the corporation. (See Table 2-B). Effective operations require a constant balancing and reassessment.

AT&T's real estate philosophy is to provide space to each user-group at a competitive cost of occupancy within the market while simultaneously generating long-term value where possible. The effect of that approach is that they
take the deep concessions offered by developers in soft markets like Denver and Houston, but participate in ownership where profit potential still exists for developing space.

Xerox Corporation has instituted a complete strategic program that is designed to deal with these conflicts through the use of joint ventures and ongoing performance evaluation. Every company interviewed expressed some difficulty in balancing the conflicting objective. Those who appear to be the most successful have implemented internal measures that they try to adhere to.

| TABLE 2-B |

**DYNAMICS OF INTERNAL CORPORATE CONFLICT**

<table>
<thead>
<tr>
<th>TIME HORIZON</th>
<th>OPERATING GROUPS</th>
<th>REAL ESTATE GROUPS</th>
</tr>
</thead>
<tbody>
<tr>
<td>Short-term</td>
<td></td>
<td>Long-term</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>EARNINGS PERSPECTIVE</th>
<th>OPERATING GROUPS</th>
<th>REAL ESTATE GROUPS</th>
</tr>
</thead>
<tbody>
<tr>
<td>Pre-tax profits</td>
<td></td>
<td>After Tax cash flow</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>VALUE PREFERENCE</th>
<th>OPERATING GROUPS</th>
<th>REAL ESTATE GROUPS</th>
</tr>
</thead>
<tbody>
<tr>
<td>Short term gains</td>
<td></td>
<td>Cash flow &amp; appreciation</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>DESIRED DEBT RATIO</th>
<th>OPERATING GROUPS</th>
<th>REAL ESTATE GROUPS</th>
</tr>
</thead>
<tbody>
<tr>
<td>Low or debt desired for operations</td>
<td></td>
<td>High</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>FACILITY LOCATION LAYOUT &amp; DESIGN</th>
<th>OPERATING GROUPS</th>
<th>REAL ESTATE GROUPS</th>
</tr>
</thead>
<tbody>
<tr>
<td>Image unique to enterprise; or low cost of</td>
<td></td>
<td>Configure to &quot;fit&quot; market; speculative</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>FACILITY STANDARDS</th>
<th>OPERATING GROUPS</th>
<th>REAL ESTATE GROUPS</th>
</tr>
</thead>
<tbody>
<tr>
<td>Maximize utility</td>
<td></td>
<td>Maximize market value</td>
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</tbody>
</table>
Can these differences be mitigated in a way that allows the corporation to maximize the value of their real estate without detracting from the primary corporate objectives? The essence of this paper is that the conflicts can be minimized by a real estate group that is organized to strategically assess and respond to the corporate operational objectives. For the firm with the appropriate operational characteristics and needs, a joint venture with an experienced real estate developer provides the vehicle for maximizing value of corporate real estate while supporting primary corporate operations.

C. CRITERIA FOR CORPORATION JOINT VENTURE VIABILITY

Joint ventures to develop real estate may represent a significant change in the way a corporation does business. There are numerous conflicts and complexities that require a different approach than conventional corporate real estate procedures. The suggestions in this section are based on my observations of corporate ventures and the literature on joint ventures in general.

This section outlines and defines some of the standards for judging or deciding whether a joint venture is a viable alternative given the needs and characteristics of a corporation. Viability is defined by its compatibility with the corporate framework and likelihood of making a worthwhile contribution towards corporate objectives. The ideas were mostly derived from comments of interviewees currently involved in corporate joint ventures.
o Interest and Motivation:

The most essential ingredient for success of a joint venture approach to developing real estate is the interest and motivation of corporate management. Many companies have a prescribed approach to the management of their real estate assets which they have no intention of changing. For example, many manufacturing based corporations have unique space requirements to serve their manufacturing operations. In most cases, they have developed a cadre of in-house capabilities to design, build and maintain these facilities. Their facilities are built, as needed, to fit the specific requirements of the firm. About the only motive to involve a developer would be to gain access to a site controlled by the developer. Otherwise, the zoning and approvals would be handled by attorney's construction, design done internally and no marketing or management would be required; so the developer has little to offer that they don't already have.

Without the interest and motivation of corporate management, the impetus to orchestrate and manage a complex joint venture structure would be insufficient. The driving force must be instituted or strongly supported from the top.

o Autonomy:

One characteristic of most corporations who have successfully put together and operated a joint venture, is some degree of autonomy for the real estate function or top
management active in executing the program. The manager of the corporate entity of the partnership must be able to make financial and operational decisions quickly. The development process is characterized by the need for quick reactions since markets fluctuate, political climates change and each project is substantially unique. One reason early corporate entrants into development failed was their inability to respond quickly. Not only does the development process require quick response, but the developer's management style and culture is so oriented. To have a compatible partnership arrangement, management styles must be symbiotic.

 o Capable Internal Management:

 Joint ventures are complex and require a great deal of managerial attention to form and effectively manage. The management team on the corporate-side must be competent in dealing with internal complexities (such as, satisfying operations groups) as well as negotiating favorable terms with developer partners who are more familiar with the product than they are. The real estate management team should be familiar with real estate and the facilities needs of the corporation. Familiarity with corporate financial principles is also a must.

 o Proactive Management Strategy:

 From an internal perspective, the management style most likely to work for joint venturing and development is proactive rather than reactive. Managers need to be able to
look forward and capture opportunities rather than respond to crises. The response time is already slow due to the nature of the development process. By preparing in advance, the corporate real estate department can make profit-oriented decisions that are also more likely to reduce occupancy costs. The typical response-oriented approach looks to find space only when the need is imminent. As a consequence, they scramble to find a space for which they have to pay premium prices.

o Appropriate Corporate Characteristics:

Certain corporate characteristics are requisite for joint ventures to be an attractive and viable alternative. The availability of surplus corporate land is a prime example of one such characteristic. Most such characteristics are difficult to express in absolutes. These financial and operational attributes should be considered in evaluating the appropriateness of a joint venture. Tables 2-C and 2-D outline some of the characteristics as if they were bipolar ends of a continuum and makes broad generalizations. The characteristics demonstrated on Tables 2-C and 2-D are exemplary. They are to be considered within the whole range of corporate characteristics, not as stand alone determinants of whether a joint venture is "right" or not. The better the fit of corporate attributes, the more likely the chances of success.
The following discussion will give an idea of the cycles in the business where joint venture development should be given a consideration. The conclusions are general rather than definitive and can, therefore, be applied by analogy only to the specific situation of a given business.

- **Contracting Market:**

  A firm in a contracting market, such as the oil or steel industries in recent years, will be looking to consolidate and perhaps liquidate their real estate assets. A primary interest may be to determine ways to convert real estate into cash. This may be an opportunity for development ventures, but may also indicate a pure need to package and sell. Either way, knowledge of the business cycle will aid the corporate real estate manager to structure ventures which reflect the corporate strategic interest of consolidating assets and generating cash.

- **Mature Market:**

  A mature market may provide the prime opportunity for real estate joint venturing. The corporation may be looking for opportunities for pooling corporate earnings and at the same time reducing occupancy costs. The "off-balance-sheet" methods of structuring development ventures allow for accomplishment of both objectives. Consolidations of space requirements into joint ventured facilities can allow the corporation to take advantage of premium locations and save money. The cash generated by the stable market in the
primary business line can be efficiently utilized in development of real estate assets.

In addition, by investing in land and buildings in strategic areas during mature, profitable, cycles companies can preserve the strategic tactic and financial flexibility of effecting a sale/leaseback at a time when the capital market might be expensive.

- Expanding Market:

In this stage corporations are least likely to be in a position for joint venturing. Cash needs will be the greatest and the company will be in need of maximum flexibility. The company will want to have flexible occupancy terms that can respond to quick changes. Ownership is not necessarily most conducive to those objectives. Recognition that the market will not expand forever must be made so that the real estate assets do not bring about the demise of the company as the expansion cycle reverses. Heavy expenditures for fixed assets in a cash-poor cycle can be detrimental to the company's growth as well as eventual stabilization.\textsuperscript{14}
<p>| TABLE 2-C |
|---|---|---|
| --- | <strong>GOOD CANDIDATE</strong> | <strong>WEAK CANDIDATE</strong> |
| 1. PROFITABILITY | Highly profitable &amp; stable earnings growth. | Declining quarterly margins; Need to show current quarterly earnings. |
| 2. CASH FLOW | Surplus cash; needs reservoir for cash. | Needs short-run consistent cashflow yet cash flow is down. |
| 3. INVESTMENT HORIZON | Long term. | Short term. |
| 4. RISK POSTURE | Accepts calculated risks yet seeks to share risks. | Highly risk averse |
| 5. DEBT TO EQUITY | Low debt. | High debt. |
| 7. INCOME STABILITY | Stable or growing. | Declining. |
| 8. TAX NEEDS | Tax benefits can be utilized. | No use for tax benefits. |</p>
<table>
<thead>
<tr>
<th>OPERATIONAL CHARACTERISTICS OF A Viable Joint Venture Candidate</th>
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</thead>
<tbody>
<tr>
<td><strong>GOOD CANDIDATE</strong></td>
</tr>
<tr>
<td>1. ORGANIZATION OF REAL ESTATE DEPARTMENT</td>
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<tr>
<td></td>
</tr>
<tr>
<td>2. LAND OWNERSHIP</td>
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<tr>
<td>3. BUSINESS TYPE</td>
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<td></td>
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<tr>
<td>4. INDUSTRY CYCLE</td>
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<tr>
<td></td>
</tr>
<tr>
<td>5. LOCATIONAL PREFERENCE</td>
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<tr>
<td></td>
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<tr>
<td>6. SPACE REQUIREMENTS</td>
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<tr>
<td></td>
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<tr>
<td>7. SPACE NEEDS</td>
</tr>
<tr>
<td></td>
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<tr>
<td>8. DEVELOPMENT CAPABILITIES</td>
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</table>
Compatible Partner:

A partner with development skills and professionalism, who is responsive to corporate needs and objectives is essential to joint venture success. Of those interviewed for this research, only two have had problems with joint venture partners. One was attributed to the lack of communication, the other incompatibility in management style. The developer partner should contribute skills not possessed by the corporation, yet they both should have fundamentally similar management philosophies.

Economically Sound Project:

All of the right partnership ingredients and corporate characteristics will do little to help an economically unsound project succeed. Careful scrutiny of the market and projected cash flows should be conducted before committing to the venture throughout the analytical process recommended in Table 2-A. The corporate partner has a fiduciary duty to scrutinize the economics and not just rely on the developer's projections. Market studies in speculative phases should consider net expected absorption, in light of competing projects built and anticipated. Financial risks should be weighed and all appropriate measures of risk reduction put into place. In short, the corporation must assure that the project will be viable on its own merits, not simply because of the corporate presence.
D. CORPORATE SCENARIOS FOR JOINT VENTURE DEVELOPMENT

The best conceived plan has little chance for success if it does not "fit" corporate characteristics. In this context corporate characteristics are those operational and financial attributes that make up the current direction of the company. This section begins with some case examples that are drawn in large part from actual experiences. The examples represent corporate attempts at resolving the real estate use issues from primarily an operational standpoint. The purpose of the examples is to demonstrate how corporate characteristics impact the decision to joint venture. The characteristics from Tables 2-C and 2-D are used in the examples. Elements from the decision model in Table 2-A are also employed. The illustrations and discussions are meant to be illustrative, not exhaustive. Factors which influenced the alternative selected are listed after each case. The attributes are condensed into some conclusions and discussions further on in the text.

EXAMPLE 1:

Corporation A1, a rapidly growing, high-tech firm wanted to develop their corporate headquarters on a site adjacent to their current home office. The site was purchased several years previous in anticipation of such an opportunity. The corporation intends to occupy the entire building as the need arises, but may lease out portions at first, depending on the rate of growth in the interim. There is no in-house development capability. In fact, corporate
real estate is handled by a small staff of facilities people, yet the firm has very well-defined corporate policies relating to building type and internal floor layout and design. Corporate earnings are strong and they have large cash reserves. As the decision was made to develop the site, the company hired a consultant and contacted local bankers and brokers to gain direction and information for screening potential joint venture partners. The joint venture was initially considered as a means of gaining needed development expertise. Requests-for-proposals (RFP's) were sent to potential joint venture partners and responses received and evaluated. A thorough review of corporate objectives, financial strategies, and growth profiles was made in light of the various development alternatives. The decision was made to develop and own the site themselves and to hire a developer on a fixed-fee basis for development and management services. A second request for proposal was sent on that basis and the developer selection was made.

Factors:

- Unique site
- Value in land to be captured
- Sole occupancy intended by owner
- No intention to leverage corporate tenancy
- Speculative space only short-term if at all
- Needed to gain development expertise
- Corporation earnings were high
- Credit and cash position strong
- Project easily managed adjacent to home office
- Corporate headquarters design not standard speculative
- Financial capacity to own outright
In this instance a joint venture was deemed inappropriate although many of the characteristics would support a joint venture. The company was not anxious to share the appreciated value of its foresight in purchasing the land with a developer who shared little risk. They found a means of achieving their objectives, and desires for control and flexibility without sharing in the value. While they lacked development expertise the project was immediately adjacent to corporate headquarters where management and control could be easily exerted. It was felt that the developer had sufficient incentive to manage the project well without a "piece of the upside".

EXAMPLE 2:

Corporation B2 is a Fortune 500, high-tech and manufacturing firm with international manufacturing and marketing space needs that are growing rapidly. Over time the corporation has developed a strong cadre of engineering, construction and architectural capability. Most all of their space needs are unique and require special engineering. The design must allow for easy adaptation to changing manufacturing needs. Their facilities are typically housed in one-two story, industrial or R&D environs but have very unique build-out requirements such as loading-docks and above-standard floor loads, electrical and HVAC requirements. Typical speculative location characteristics for their developments are not necessary. Prestige or proximity to major centers is not important, but
cost and availability of labor force are. Design style is also of little importance. For this company, in a highly strong cash position, a joint venture is not considered a viable option. Instead they build and own the majority of their manufacturing facilities and lease the smaller marketing spaces under flexible terms. The corporate borrowing capacity and credit allows them access to debt financing at rates much more favorable than typical mortgage rates.

Factors:
- Manufacturing firm
- In house, design construction and engineering capabilities
- Above standard engineering requirements
- Needs oriented corporate philosophy
- Special purpose type buildings
- Little risk in type of single use projects
- Obtain financing from corporate paper market
- Strong credit and debt capacity
- Favorable debt terms through corporate bonds

Company B2 has the capability to handle most of their needs in-house. They employ several engineers, construction managers and designers. They are not concerned with building space that is highly marketable, but want it responsive to their own needs. With few exceptions, their office space is generic. So what can a developer offer? Engineering and construction skills are available within. The corporation can hire the same attorney that a developer would use to gain approvals.

The financial and marketing risks are virtually non-existent since they don't intend to share facilities or
space or build in a research park. So, they build what they have unique needs for and lease the rest. Corporation B2 is the prime example of the type of company that is not likely to benefit from a joint venture. Their space requirements are much different than those of a speculative market so the only motive for building additional space is for their own future expansion. Furthermore, the corporation is not seeking to share risks or gain expertise. Value is best captured by providing cost efficient manufacturing facilities that meet their standards.

EXAMPLE 3:

Corporation C3 owns several thousand acres of surplus developable properties across the country. Many of these properties have been on the corporate books for over ten years and have market values that are several times book value. The corporate financial posture has been weak as its primary business lines are in down-cycles. There is a strong need to generate earnings and at the same time minimize risks. C3 has sold several properties only to watch the investor/developer make considerable profits in a relatively short time by packaging or resaling. The company has commissioned studies to determine which of the properties in their portfolio have the greatest potential and to determine the highest and best uses for each property. At least one solo attempt to develop land brought about losses when the market was inaccurately assessed. C3 desires a way to capture the value in their assets, yet, they don't have the
development expertise. They are also concerned about the conflict between real estate value realization and the need to book short-term earnings. The corporate parent does not want to incur more debt.

Factors:

- Surplus property
- Need of development skills
- Desire to capture value, yet minimize risk
- Interest in learning the development business
- Previous difficulty in assessing the market
- Need to keep debt off balance sheet of parent

The corporation opted for joint venture development of several properties in order to gain the development capabilities and capture a portion of the value added by the development. The surplus properties were underutilized, but had latent values which could be captured. The financial characteristics of this firm give reasons for skepticism about the viability of a joint venture approach. However, in light of other alternatives (lease, sell, hold, or develop alone), capturing value through the joint venture approach may prove to be most advantageous in the long run. C3 may want to limit its investment to the packaged value of the land (i.e. at the highest and best use) as well as require developer guarantees. A limited partner position would minimize risk, but may preclude the opportunity of gaining development skills for use in the future.

EXAMPLE 4:

Corporation D4 is a large blue-chip company with international presence. The corporate earnings are stable.
Growth projections are constant. They have offices in virtually every large metropolitan area in the country. Some of the space has been used inefficiently. While the company can gain tremendous concessions by virtue of it's size and strength, they have found that an ownership position allows them to lower occupancy costs by leveraging the value of their presence and blue-chip credit. They have also found that their presence adds value, to surrounding users and owners of space, that can be captured through ownership. The corporation has a well-staffed internal real estate division that manages all real estate and facilities needs and reports at the corporate level. The space requirements allow potential for concentrating staff and facilities in large cities. The corporate image is important so corporate design is important in conveying that image. Nonetheless, space needs are equivalent to first-class speculative office.

Factors:
- Space needs roughly equivalent to speculative office
- Large corporation
- Strong credit
- Tenancy adds value
- Prime locations important
- Long term growth expectations
- Control of design important
- Need to consolidate occupied space

A joint venture provides the best alternative in this case since the corporate user can leverage its desired tenancy to share in its value. The developer gets the credit tenant and the corporation can reduce effective occupancy costs and improve upside potential. The dichotomy
between earnings horizons of the primary business and real estate is smoothed by the use of "off balance sheet financing". The real estate subsidiary is set-up as an unconsolidated subsidiary so that only the equity investment shows up on the parent's balance sheet.

EXAMPLE 5:

Corporation 5E is in a high growth mode and needs to funnel earnings to fuel continued growth. Since growth is occurring so rapidly, it is difficult to accurately predict space needs. Their space needs at this point are primarily for suburban office or R & D type buildings. Long-term commitments could impede needed flexibility. Cash resources are minimal. Corporate energies and resources are predominantly oriented towards growth and market access.

Factors:

- High growth
- Need for flexibility
- Cash poor
- Management intent on fueling growth
- High risk profile
- Highly leveraged

For this company in the short-term the best alternative is to lease their space. The need for flexibility would probably require the use of more expensive, short-term leases. They have little leverage as a high risk, growth oriented company. Long-term commitments as owner or venture partner may prove destructive in the event of cash squeezes or plateaus in the business cycle - a risk that the board is not anxious to take.
EXAMPLE 6:

Corporation F6 is a large, regional firm whose real estate needs are very site-specific. Each site must fit a set of criterion. In order to gain access to certain desirable sites the company often does joint ventures with the developer/landowners. Otherwise, they try to own a substantial number of the sites they use. The motive in virtually every site decision is location. Demographics and prestige in location are all important. When a site is desired they will consider a variety of alternatives. All sites are leveraged so that cash can be funneled to the main business line. They are only interested in real estate as a means to accomplish their corporate objectives. In most cases, the developer must carry 100% of the development risk since the joint venture is not signed until the development is virtually complete.

Factors:

- Risk averse
- Ownership a good choice
- Site specific needs
- Flexible management approved
- Secure cash position

A joint venture for this company is a good idea, but perceived, primarily, as a financing option. The corporation has the capability to manage its own building program and has built for its own account. F6 understands the zoning and approvals process and knows the market for its own needs. The key to the joint venture here is access to the site.
The preceding examples are intended to illustrate the circumstances under which a joint venture approach to providing corporate real estate needs is appropriate. It is clear that the developer liaison is not beneficial in every circumstance. Virtually, all major corporations have some combination of leased and owned space. The decision to go one way or the other, is often based on some criteria or needs characteristics. Joint ventures should become a part of that decision process for corporations who may benefit from them. In essence, the analysis has produced three broad categories of potential beneficiaries of joint venture development alternatives: 1) the corporation with strong credit and speculative needs - who is interested in leveraging its tenancy, 2) the corporation with surplus developable property, and, 3) the corporation with unique locational preferences desiring to gain access to a particular site.

E. CORPORATE JOINT VENTURE PROFILES

There are three dominant profiles which seem to fit the scenarios and criteria necessary for corporate joint ventures: 1) credit leveraging development, 2) surplus land development, and 3) location seeking development.

1. Credit leveraging development:

This alternative offers a means for a large corporation to leverage the value of its tenancy by participating as development partner in a project in which the corporation is
essentially the anchor tenant. It is a situation similar to that used by anchor tenants in major malls. The difference is that instead of reducing occupancy costs through lower rents the corporation takes an ownership position and thereby, participates in the cash flows, tax benefits, appreciation and eventual sale of the entire development.

The strategy used by Xerox is to set up a joint venture with a reputable developer. The venture might develop a phased project wherein the parent corporation occupies roughly half of the space as anchor tenant to the project. The corporate partner to the joint venture is a wholly-owned, unconsolidated subsidiary of the parent. The subsidiary maintains an arms-length relationship with the parent corporation tenant. The subsidiary, thereby, allows separation of operating costs from investment costs on the consolidated balance sheet. The parent corporation reports its participation as an equity investment in the unconsolidated subsidiary. The asset value and debt are carried on the subsidiary's books. The corporation gets benefits of premium office space with expansion capabilities for the operating groups as well as incremental profit and positive cash flow on a major real estate investment without affecting the overall balance sheet structure.  

2. Surplus land development:

The corporation who owns significant parcels of developable land yet lacks the in-house development expertise is a likely candidate to benefit from a joint
venture. Corporations that typically fall into this category include: transportation, timber, paper, manufacturing and natural resource companies. By entering joint ventures with developer partners, they can gain development expertise for specific projects and perhaps that knowledge may also enable them to eventually embark on development themselves. In addition, they gain value beyond what they might normally expect from a sale by capturing the value added through development. Their actual return on investment may be greater to the extent that the land value is improved by the development effort and/or the developers capital contribution.

The development of surplus corporate land is certainly not trouble free. Markets must still be tapped and the development process still needs management. Many are reluctant to pursue the resource because as they see it "the profit potential doesn't exist or because of the adverse effect the development process has on short-term profits". A steel company reports leaving the real estate development business because of its "inability to move fast enough" to capture the market.16

However, the companies still involved in real estate development today are those with large amounts of surplus land. The study concludes that these corporations reflect the survival of the fittest and are not representative of typical corporate behavior.17
Available to a company with surplus land include: holding, selling, packaging and selling, packaging and joint venturing, and developing the properties. The option recommended here is to package the property and jointly develop it with an experienced developer.

Packaging "entails some effort on the part of the corporation to, a) determine the highest and best possible use of the property in the current marketplace, b) study the alternatives to attain the best use, c) obtain necessary zoning and approvals, and d) market to a developer partner with increased potential value."

One firm requires that the developer prepare the design and obtain construction contracts and financing arrangement and marketing studies before the corporation will relinquish rights to the land. The corporation can, thereby, reduce its risk immensely before it commits the resources. The developer brings expertise and shares the risk with the corporation who contributes the land - which is valued higher because of the prepackaging efforts.

3. Location seeking development

The third profile of a likely corporate joint venture candidate is one who enters a joint venture in order to secure a desirable property. The most likely scenario is one where the corporation desires a parcel adjacent to one they currently own or they want one in a highly desirable or prestigious location.
One company structured such a joint venture in order to develop a research campus around their headquarters. The corporation contributed the lease and the landowner contributed a parcel valued at $3 million towards an eventual $10 million development. The corporation would have less than $500,000 cash in the project (for initial site work and planning studies) all of which would be recouped upon funding of the construction loan. The developer was liable and at risk during the development process. Upon completion, the liability would be shared.

A big issue in this scenario is how the land is valued and when the value for it is recouped. A developer/landowner may want to recover value as soon as possible and will likely want the highest possible price. It is in the corporation's interest to not be obligated for the purchase of the land until the development is substantially completed. However, the corporation may want the land valued at the landowners cost basis, or at least at its predevelopment value.

The same benefits found in the credit leveraging profile can be structured into this profile or the corporation can be a sole occupant of the space. Being sole occupant takes away the speculative risk, but it always takes away a large portion of the benefits of developing in the first place. For example, the corporation would not be able to capitalize on the external benefits of its location.
decision unless there were additional space.

What makes for the effective joint venture strategy? How can the drawbacks of such ventures be overcome? Certainly the first step is to ensure that the joint venture is well conceived and mirrors the objectives of the corporation. Earlier studies of corporate real estate ventures revealed that "often the key executives and technical staff had not really identified in their own minds what their own objectives were". 19

For example, the role that real estate plays in the corporate strategic plan will be significantly affected by the macro trends within the primary business cycle of the corporation. Discussions with corporate real estate managers have revealed that business cycles are predominant influences in their decision criteria.

Throughout the evaluation and decision-making process a corporate manager's focus must be continually redirected toward the two most important criteria: 1) Does the project "fit" or enhance corporate objectives and strategies and; 2) does it make economic sense? Far too many well-meaning corporate executives have led their companies into disastrous real estate ventures because it was the popular thing to do or because of a hidden aspiration to develop real estate.

Corporate joint venture partners may be able to realize
substantial increase in equity without incurring charges against corporate earnings or balance sheet liabilities. With careful planning a joint venture can result in enhanced long-term cash flow without significant diminution of current quarter earnings. By bringing in an experienced and capable developer, these ends can be achieved without the risk of building in-house development capabilities. Achieving those ends, however, often taxes the ingenuity of the best managers, accountants and lawyers.\textsuperscript{20}
CHAPTER THREE

UPSIDE AND DOWNSIDE OF CORPORATE JOINT VENTURES

"Babies are in fashion again, and many U.S. firms are rushing to find partners with whom to form joint ventures... Joint ventures need as much attention and support from their parents as do babies." 1

If it has not already become clear it must be emphasized that corporate real estate development joint ventures are not for everybody. In fact this paper has isolated some specific characteristics of candidates most likely to benefit from and succeed in a joint venture approach to corporate real estate. This chapter explores the pros and cons for those "preferred" candidates. The final section describes three "ideal" corporate joint venture profiles.

Even those for whom a joint venture approach is likely to be advantageous will have risks and concerns to consider. The risk of failure is not inescapable in any venture. Potential drawbacks and the causes of failure among joint ventures in general are considered herein, so that efforts can be made to circumvent or insure against them. The potential rewards are discussed briefly followed by a primer on planning to overcome the negative attributes in favor of the positive. This is a chapter of lists. Some discussion
is used to elaborate on the issues listed but the intention is to explore the breadth of drawbacks and benefits rather than detail their implications in general sense.

One caveat is in order. Even those corporations with all the ingredients for success in place, must perform careful analysis and consideration of the unique aspects of each project. For therein lies the greatest risk—failure to plan and analyze the individual project in light of its constraints and opportunities. While many corporate failures in real estate development may have been precipitated by unforeseeable circumstances many more resulted from quick decisions and aims to "follow the crowd."²

A. DRAWBACKS TO CORPORATE/DEVELOPER JOINT VENTURES:

"Same bed, different dreams"
- Old Chinese proverb

The primary concern of this section is to alert the venture candidate to some of the problems encountered by others. The theory is that awareness of potential problems will incite caution and preparation where possible. Table 3-A lists a compilation concerns raised in interviews and in business literature.³ The listed drawbacks are not absolutes. Many drawbacks can be avoided by careful planning that is accurately reflected in the agreements and documents of the venture. Management controls can be implemented that minimize risk and optimize benefits.
TABLE 3-A

DRAWBACKS OF CORPORATE/DEVELOPER JOINT VENTURES

1. Detracts from primary line of business
2. Loss of control over corporate assets
3. Risk of financial loss beyond investment
4. Opportunity cost of time and financial investment
5. Developers are frequently undercapitalized
6. Loss of strategic flexibility
7. Drain on corporate resources and personnel
8. Potential adverse affect on corporate name or identity
9. Conflict with requirement for current earnings
10. Possible negative impact on balance sheet ratios
11. Exposure to additional financial risk
12. Loss of strategic or internal flexibility
13. Difficulty to "get out" when needed
14. Conflict with developer's interest in deferred earnings
15. Increased complexity
16. Interest rate fluctuations
17. Political disincentives to propose internally
18. Developers design criteria may not be in best interest of the user
19. Slow and time consuming to set-up venture

In addition to the market and financial risk inherent with any real estate development, a corporate venture partner is exposed to internal and exogenous risks from the introduction of a partner to the picture. As with any marriage, a second party introduces a spectrum of new variables. The energies required to manage the new venture could detract from the primary line of business. Some corporate structures are not organizationally prepared to accept a new partner. Previous studies have indicated that
having partners means that the decision-making process will be more cumbersome.\textsuperscript{4}

Perhaps the most significant drawback for the public corporation is the conflict between the requirement of short-term, booked earnings and the typical cash requirements and flows of real estate development. However, accounting measures can be implemented, wherein, even that constraint can be minimized.

The unknown variables and potential loss of control to the developer partner is another drawback. Actual or perceived loss of control can be difficult for managers. One manager stated that "when you give up control, you give up your own destiny, and that conflicts with one's obligations to shareholders."\textsuperscript{5}

B. WHY JOINT VENTURES FAIL:

Corporate joint ventures in general do not have the most stellar record. They frequently go awry and cause problems. One drawback which eventually leads to failure is due to the relative inexperience of firms using such ventures.\textsuperscript{6} Obviously the firm can get better at this with experience. Another is the owner's abilities to manage ventures effectively. The issues raised in this section are to help managers avoid common and previously experienced problems.
### WHY CORPORATE/DEVELOPER JOINT VENTURES FAIL

1. Inexperience in dealing with outside partners
2. Incompatibility with partner
3. Lack of communication
4. Lack of management support and continued attention
5. Sharply different management styles, motivations or commitments.
6. Failure to agree in advance on how to run the business
7. Different perceptions among partners of what is important
8. Poorly conceived motivations and business strategies
9. Leveraging beyond the capacity of the project
10. Inaccurate assessments of the market potential
11. Business failure of one of the venturers
12. Poor planning resulting in unrealistic or erroneous action
13. The Time schedules are overrun
14. The "costs go crazy" (in the immortal words of one builder)
15. A partner loses interest or sells its interest
16. Conflicting objectives
17. Lack of follow-through
18. General economic conditions

The most often cited reasons for failure or difficulty within joint ventures were incompatibility and lack of communication or trust among partners.

Independent studies by McKinsey & Co. and Coopers & Lybrand reveal that "some 7 out of 10 joint ventures (in general) fall short of expectations or are disbanded". There have been no specific studies to indicate whether that same ratio would apply to development joint ventures but
many of the factors contributing to joint venture viability are the same.

Failures can largely be categorized in three broad arenas: 1) Partnership incompatibility, 2) Inaccurate assessment of market, financial or development risk, 3) Inabilities to manage ventures effectively. The first can be managed largely by careful selection of the partner. The other two are largely functions of managerial skill, experience and luck. To deal with the drawback of incompatibility requires an up-front recognition that a corporation and a developer each has its own agenda. The interests are often conflicting. A clear recognition of the different interests can open the door to creation of synergies and management of differences. Careful selection of a compatible partner is essential. Some managers suggest a step-by-step relationship or long engagement periods.  

Conflict and disruption can come from differing perceptions of the relative importance or value of some issue. An illustrative example is the perceived value of a corporate anchor's name on the development. A large, well-known corporation like Xerox is confident that prominent display of their logo adds value to the development. Their development partner may strongly disagree with that perception because the displayed logo may deter certain tenants from the project. As simple as it may seem, such differing perceptions can lead to disrupting conflicts if
not properly managed.

One joint venture discovered the sharply different management styles between the parties. The developer partner wanted to lock-in on a permanent loan rate; the corporation preferred to wait but finally agreed to sign-off on the commitment. When rates reversed, an internal conflict heated up. In another instance the partners disputed as to the timing of equity investment and distributions. There were big arguments that eventually ended up in a buyout.

Real estate development is a high risk endeavor. A lot of efforts and resources must pour in before any return is realized - particularly in developing raw land. A joint venture with a developer partner can alleviate some of the risks which have impacted previous corporate entrants since the corporation has the benefit of the developer's expertise and commitment. The financial and marketing risk inherent to the industry will nonetheless persist. The financial risk if the project fails midstream or if the developer partner walks away could be devastating. Even as a limited partner the risk of loss could go beyond merely the amount of invested capital. Foreclosure or liquidation in some instances mushrooms losses. The Internal Revenue Service requires "recapture" of some tax write-offs previously taken. This discussion of the risk inherent to real estate argues primarily that the corporation make its own assessment of the market, financial, and development risks and that it scrutinize the developer's and consultant's
perceptions. Attention should be paid to the realistic expected market demand, and net expected absorption (not gross absorption net absorption also considers lateral moves and expected supply relative to the market). Corporate presence in the project and the corporation's partnership mitigates much of the risk. Cautions should be taken to scrutinize and avoid that which remains.

Once the partner has been selected and the joint venture has been consummated, the viability of the project depends largely upon the strength of its management. Failure can be avoided by management of the process and by taking risk avoidance measures. The management of risk includes abiding, transferring or minimizing the factors which are involved. A few pragmatic suggestions follow:

- Carefully assess the location decision relative to market conditions
- Avoid recourse debt and let the project stand on its own financial merits
- Take a partnership position (limited or general) which coincides with risk posture and amount of control needed
- Carefully monitor purchase prices of land and services for relevance to market
- Institute and constantly monitor the project with good accounting and cost controls system
- Conduct ongoing feasibility research
- Make sure the economics of the project stay within corporate risk/return parameters

Finally, the definition of failure may depend upon expectations coming into the venture. Failure to some corporations may simply mean that the project did not meet return criteria. While studies have shown that returns from
real estate development are consistently higher than other investments, the experiences of some prove otherwise.\textsuperscript{9} Atlantic Richfield was at least one corporation that got out of corporate joint ventures because of inadequate returns. They wanted to concentrate on the energy business. \textsuperscript{10}

C. BENEFITS OF THE JOINT VENTURE APPROACH

A corporation that fits the characteristics described in chapter two stands to reap tremendous long-term benefits from a properly structured and well-managed joint venture. In the first place a joint venture is a means of circumventing many of the most serious risks of solo corporate development. It also provides a means of capturing latent values in corporate real property assets as well as reducing occupancy costs. Risk is reduced by "sharing" ownership. In essence the joint venture is a synergistic means of mingling talent and needs to fulfill the corporation's needs. Other benefits are outlined in Table 3-C.
TABLE 3-C

<table>
<thead>
<tr>
<th>BENEFITS OF CORPORATE/DEVELOPER JOINT VENTURES</th>
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<tbody>
<tr>
<td>1. Control (vs. lease)</td>
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<tr>
<td>2. Gain developer experience w/o cost of acquisition</td>
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<tr>
<td>3. Access to real estate beneficial to the corporation</td>
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<td>4. Capture value in real estate usage</td>
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<tr>
<td>5. Reservoir of corporate earnings</td>
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<tr>
<td>6. Optimize value of surplus corporate real estate</td>
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<td>7. Learn the development business</td>
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<td>8. Cost and risk sharing</td>
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<td>9. Optimize space utilization</td>
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<tr>
<td>10. Leverage credit tenancy</td>
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<tr>
<td>11. Reduce occupancy costs</td>
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<tr>
<td>12. Vehicle for attaining corporate real estate objectives</td>
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<tr>
<td>13. Opportunity to test technologies from main-line business</td>
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<td>14. Long-term profit center</td>
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<td>15. Tax benefits</td>
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<tr>
<td>16. Off-balance sheet financing</td>
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<tr>
<td>17. Flexibility in structuring to meet corporate needs</td>
</tr>
<tr>
<td>18. Opportunity to consolidate operations in large markets</td>
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</tbody>
</table>

The most obvious benefit in teaming up with a developer is that the corporation gains access to development expertise and knowledge. Most corporations do not have the in-house capability to manage the development process - much less understand the market. In one firm, the executives felt that they lacked the "sixth sense" needed to make a profit in real estate development. It was felt that successful private real estate entrepreneurs bring this ingredient to their projects; but, corporate managers often cannot perform in the same way or with the same success. Furthermore, corporations are not able to attract the type of talent needed to manage the process for them. They can't provide
the autonomy nor the financial incentives that are needed to attract qualified people.

D. PLAN FOR SUCCESS:

This section briefly outlines some strategies for overcoming the aforementioned drawbacks and causes of failure. It provides a checklist of the major areas that are key to a successful joint venture program. The discussion is brief and general since the following chapters describe a practical model for structuring the joint venture and necessary documentation.

TABLE 3-D

| STRATEGIC OPTIONS FOR ENHANCING JOINT VENTURE SUCCESS (MINIMIZING RISKS) |
|---|---|
| 1. Careful selection of a partner |  |
| 2. Gain commitment of top management |  |
| 3. Plan and document scope and intent carefully |  |
| 4. Know your own constraints and objectives |  |
| 5. Minimize the impact on earnings - subsidiary accounting |  |
| 6. Non-recourse debt |  |
| 7. Structured to be able to make changes quickly-response |  |
| 8. Preserve the ability to get out when needed |  |
| 9. Test and affirm realities of pro forma assumptions |  |
| 10. Joint venture agreement that details parameters |  |
| 11. Monitor the development process |  |
| 12. Obtain personal and financial guarantees on financing and construction |  |
| 13. Ensure that developer has organizational strength to deliver on time |  |
| 14. Seek creative alternatives to conflicting objectives |  |
| 15. Leverage within capacity to cover debt |  |
| 16. Ongoing financial, market and operational feasibility studies |  |
| 17. Risk reduction, transfer or minimizing |  |

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Despite the potential drawbacks and the risks of corporate joint venturing to develop real estate, there are many advantages to be gained by the synergistic juncture of developers and corporations. The benefits are situation-specific. Joint ventures bring the viewpoints of new players (partners) and the result can be a stronger, hybrid champion if managers can channel the interactions between the venture and the corporate parent.
CHAPTER FOUR

GUIDELINES FOR PROPERLY STRUCTURING THE VENTURE

"A company's competitive situation no longer depends on itself alone but on the quality of the alliances it is able to form."

- Bruno Lamborghini, Economics Director - Olivetti.

A. A CORPORATE DECISION MODEL

The most important criteria for corporate joint venture viability is economic feasibility. However, once financial feasibility requirements have been met, the qualitative issues may assume even greater importance in the decision process. The proposed joint venture should be evaluated in light of the corporate objectives, goals and constraints.

This chapter gives a broad review of the joint venture structuring process from initial inception to project realization. The first section discusses some financial and operational issues that will be pertinent throughout the process. The analysis recommended should take place within the framework of the corporate decision model in Chapter Two (Table 2-A). Each corporation has its own financial and operational feasibility approaches and valuation methods that reflect the objectives of the firm. The intent is to present a simple set of tools for starting the inquiry into the joint venture. They should not be relied upon without
careful thought and adaptation to fit the corporate needs and typical decision criteria.

Financial comparisons made on the same basis used to test other corporate investments. The approach discussed in this section recommends evaluation on the basis of the NPV (net present value), IRR (internal rate of return), and cost of occupancy. The model should be adapted to in corporate preferences regarding measures or rules-of-thumb — including ROI (return on invested capital), ROA (return on assets), capitalization rate, (measuring the relationship of net operating income to value) or hurdle rate.

The first financial evaluation model, (Table 4A) is primarily informational. It is arranged in a matrix for the purpose of evaluating proposals from several developers. The information comes from the developer's proposals, but should also be augmented (or tested) on the basis of the corporation's own estimates, as attained by research or from advisors. The model gives a single time-frame breakdown of development costs. Land is listed at the agreed price for which it is contributed to the partnership. The development costs are the hard costs, soft costs can often be derived, at first, by rules-of-thumb. Total project costs are the sum of land, development costs and soft costs; to which is added a contingency margin of error.
TABLE 4-A

FINANCIAL PROPOSAL EVALUATION MATRIX

<table>
<thead>
<tr>
<th>DEVELOPER</th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
</table>

1. Land

2. Development Costs
   - Building
   - Tenant Improvements
   - Site Improvements
   - Off-Site Improvements
   - Parking Structure
   - Surface Parking

   Total Development Costs

3. Soft Costs
   - Development Fees
   - Overhead
   - Mkt Anal. & Consult Fees
   - Title Insurance
   - Legal & Acctg. Fees
   - Loan Fees
   - Int. During Constr.
   - Taxes During Constr.
   - Broker Comm. & Mktg
   - Lease-Up Deficit
   - Linkage

   Total Soft Cost

4. Project Costs (subtotal)

   Contingency Fee

5. TOTAL DEVELOPMENT COSTS
The total development cost is conveyed onto the debt/equity mix template (Table 4-B) for the purpose of establishing debt requirement on the basis of desired equity input.

TABLE 4-B

<table>
<thead>
<tr>
<th>DEVELOPER</th>
<th>Total Development Cost</th>
<th>Corporate Equity In</th>
<th>Developer Equity In</th>
<th>Total Equity In</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
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</tr>
</tbody>
</table>

Required Debt

- Loan Commitment Fee
- Points

TOTAL REQUIRED DEBT

The most important in-depth financial analysis to determine a development project's expected return is the project's cash flow analysis. In the initial screening stages the projected cash flows should be considered on the
basis of the stabilized year (usually at some predetermined occupancy level) income and expense stream (Table 4-D).

This model pro forma (Table 4-D) does not consider tax shelter, equity build-up, time value of money nor property appreciation. These factors will be considered in more elaborate and detailed financial studies. It is a "most likely" sketch of the project's potential. The one-year cash-flow pro forma provides a basis for testing basic feasibility and deriving project value, debt/equity parameters and determining return on equity. One way of deriving the required equity investment for the project is to divide the result (cash flow before taxes) by the corporate desired rate of return. The estimated rate of return can be derived by the inverse of that function, if the equity amount is know.

More comprehensive financial analysis can be performed using Table 4-F. In this model the before-tax cash flows and after tax benefits are evaluated. It should incorporate carefully considered assumptions about construction time, lease-up time, rent estimates, escalation, and expenses. In addition, the sales price at some future point should be estimated and accounted for (in before-tax and after-tax scenarios). The disposition price can be estimated by applying a capitalization rate (CAP rate) to the NOI in the year following sale. (NOI/CAP rate = value). The projected time horizon depends on corporate preference. One firm looks at nothing over a five-year span, while another makes
assumptions that parallel the term of the lease, which typically is fifteen years. However, the longer the horizon, the greater the uncertainty of the projections.

A simplified version of the cash flow on reversion (sale) at the end of the holding period is also given in Table 4-E. The before-tax equity reversion equals the net sales price (sales price - expenses incurred for sale) minus the unpaid mortgage balance. The tax treatment on sale will be contingent upon each partner's allocation and the basis allocable to each, which is in part, affected by the amounts in the partner's capital accounts and the agreed upon distribution of benefits. In general, the taxable gain on sale equals net sales price minus the adjusted basis (which is taxed at capital gains rate) plus the depreciation recapture. However, in a partnership they are derived after allocation since the partnership is not taxed.
# TABLE 4-C

## FINANCING ASSUMPTIONS

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
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<tbody>
<tr>
<td>Permanent Interest Rate</td>
<td></td>
</tr>
<tr>
<td>Term</td>
<td></td>
</tr>
<tr>
<td>Amortization</td>
<td></td>
</tr>
<tr>
<td>Loan to Value Ratio</td>
<td></td>
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<tr>
<td>Debt Coverage Ratio</td>
<td></td>
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<tr>
<td>Supportable Loan Level</td>
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</tr>
</tbody>
</table>
### TABLE 4-D

**FIRST YEAR PRO FORMA INCOME ANALYSIS**

<table>
<thead>
<tr>
<th>INCOME</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Gross Possible Income</td>
<td></td>
</tr>
<tr>
<td>Partner tenant (X SF @ $__)</td>
<td></td>
</tr>
<tr>
<td>Speculative (Y SF @ $__)</td>
<td></td>
</tr>
<tr>
<td>Less vacancy (on spec. space)</td>
<td></td>
</tr>
<tr>
<td>Effective Gross Income</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>EXPENSES</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Operating Expenses</td>
<td></td>
</tr>
<tr>
<td>Real Estate Taxes</td>
<td></td>
</tr>
<tr>
<td>Management Fees</td>
<td></td>
</tr>
<tr>
<td>Other Expenses</td>
<td></td>
</tr>
<tr>
<td>Replacement Reserve</td>
<td></td>
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<tr>
<td>Total Expenses</td>
<td></td>
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</tbody>
</table>

<table>
<thead>
<tr>
<th>NET OPERATING INCOME</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>- Annual Debt Service</td>
<td></td>
</tr>
<tr>
<td>= Cash Flow Before Taxes</td>
<td></td>
</tr>
</tbody>
</table>
## FORECASTED PRO FORMA INCOME ANALYSIS

<table>
<thead>
<tr>
<th>YEARS</th>
<th>1</th>
<th>2</th>
<th>3</th>
<th>4</th>
<th>5</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>INCOME</strong></td>
<td></td>
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<td></td>
</tr>
<tr>
<td>Gross Possible Income</td>
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</tr>
<tr>
<td>Partner tenant</td>
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</tr>
<tr>
<td>Speculative</td>
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<tr>
<td>Escalation</td>
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<tr>
<td>Less vacancy</td>
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</tr>
<tr>
<td>Effective Gross Income</td>
<td></td>
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</tr>
<tr>
<td><strong>EXPENSES</strong></td>
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</tr>
<tr>
<td>Mortgage Interest Exp</td>
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<td></td>
</tr>
<tr>
<td>Operating Expenses</td>
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<td></td>
<td></td>
</tr>
<tr>
<td>Real Estate Taxes</td>
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<tr>
<td>Management Fees</td>
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<tr>
<td>Other Expenses</td>
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<td></td>
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<tr>
<td>Total Expenses</td>
<td></td>
<td></td>
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<td></td>
<td></td>
</tr>
<tr>
<td><strong>BEFORE TAX CASH FLOW</strong></td>
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<td></td>
<td></td>
</tr>
<tr>
<td>Less Depreciation</td>
<td></td>
<td></td>
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<td></td>
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</tr>
<tr>
<td><strong>TAXABLE INCOME (LOSS)</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Net Proceeds From Sale</strong></td>
<td></td>
<td></td>
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<td></td>
<td></td>
</tr>
<tr>
<td><strong>SELLING PRICE</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Less: Selling Expense</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Less: Unpaid Mortgage Balance</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>BEFORE TAX EQUITY REVERSION</strong></td>
<td></td>
<td></td>
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</tr>
</tbody>
</table>
### TABLE 4-F

**CORPORATE PARTNER CASH FLOW ANALYSIS**

<table>
<thead>
<tr>
<th>PARTNER INCOME ALLOCATION</th>
<th></th>
<th></th>
<th></th>
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</thead>
<tbody>
<tr>
<td>Priority return</td>
<td></td>
<td></td>
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<td></td>
<td></td>
</tr>
<tr>
<td>% share after priority</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Sales proceeds</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Tax benefit allocation</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total partner's share</td>
<td></td>
<td></td>
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<td></td>
</tr>
</tbody>
</table>

| EQUITY INVESTED           |   |   |   |   |   |   |
| AFTER TAX NET CASH FLOW   |   |   |   |   |   |   |

| NPV                       |   |
| IRR                       |   |

### TABLE 4-G

**CORPORATE COST OF OCCUPANCY EVALUATION**

| + Rent paid                |   |
| - After tax cash flow from partnership |   |

| Cost of occupancy          |   |

| OTHER OPTION               |   |
| Cost of occupancy (i.e. lease) |   |
The cash flow analysis in Table 4-F presents the expected corporate share of benefits without consideration of the occupancy costs. The net cash flow will be used to calculate the cost of occupancy in Table 4-G.

The corporate cost of occupancy model is designed to evaluate the occupancy costs realized by making the joint venture investment decision. Although the template demonstrates a single year, this model should be spread over the expected investment (or lease) period and include the upfront costs as well as expected proceeds from disposition. The occupancy costs of other alternatives (such as straight lease) can be compared either as an investment alternative or as a benchmark.

B. PROPOSAL EVALUATION PROCESS

The next section discusses some of the qualitative factors which will impact the evaluation process. A matrix of qualification issues is provided as a basis for rating each developer's proposal. Each item is briefly discussed in the following text. These issues were compiled from surveys of corporate executives who have had joint venture experience.¹ The intent of the matrix is to formalize the qualitative criteria used in the selection process.
### Table 4-H

**Developer Qualification Proposal Evaluation Matrix**

<table>
<thead>
<tr>
<th>DEVELOPER</th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Land</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>A. Size</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>B. Valuation Method</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>C. Time of Valuation</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>D. Payment Schedule</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2. Development Costs</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>A. Building</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1. Building Size</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2. FAR</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>3. Phasing</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>B. Site Improvements</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1. Existing Bldgs</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2. Site studies</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>3. Developer Experience</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>A. Type of Developments</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>B. Size Developments</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>C. In-house Capabilities</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1. Construction</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2. Construction Mgt</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>3. Marketing</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>4. Brokerage</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>5. Project Mgt</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>4. Financial Strength</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>A. Net worth</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>B. Debt/Equity Ratio</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>C. Cash Avail/Liquidity</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>D. Line of Credit</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>E. Current Commitments</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>F. Financial Partners</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>5. Current Projects</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>A. Local</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>B. National</td>
<td></td>
<td></td>
<td></td>
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<tr>
<td>6. Developer</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>A. Desired Pship Status</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>B. Capital Contribution</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>C. Loan Amount</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>D. Share of Income/losses</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>E. Financial guarantees</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>F. Split of overruns</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>G. Guaranteed Price</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>7. Proposed Rents</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
1. Land Valuation:

The value decided upon for the land is important whether it belongs to the developer or the corporation. In most cases it will represent a significant portion of contributed equity. Further inquiry should also spell out the method and time of valuation, when it is paid for, and who holds title during the development process.

2. Development costs:

Development costs and soft costs will likely be estimates at this stage unless a guaranteed price is demanded. They do provide a basis for comparison, but not one that should be determinative in selecting the developer. At this stage, the financial estimates are best used as tools for investment analysis of the joint venture and for further inquiry into the developer's assumption.

3. Development Experience:

The developer experience issue gives a basis for weighing not only the quality of experience, but the type of experience relative to a particular need. As an example, one firm requires that any developer have in-house construction capabilities which they feel are necessary for responsiveness on construction matters in special design situations. They also insist on a firm-fixed construction price so that costs are clear from the inception. Another corporation may want assurances of marketing capabilities for speculative space in a soft office market.
4. Financial Strength:

Development firms are notoriously highly leveraged. Financial strength and commitment are paramount for a corporate joint venture. The corporation will likely want assurances that the developer has "staying power" and the ability to bear a proportionate share of the risk. The financial strength analysis should be as thorough as is necessary to provide full assurance of the developer's strength and commitment to the development.

This should include careful scrutiny of time and financial commitments during the duration of the process. One firm required covenants not to compete that specified, a) the dollar value, b) percentage of time allocable, and c) distance in miles of any competing projects from the joint venture project. The restraint was also extended to related parties.

5. Current projects: (see above)

6. Developer:

This section is used to value the benefits that the developer brings, or will bring, to the venture. These issues are key in valuing the partnership share or in allocating risks. One firm uses formulas for giving increments of the partnership depending on relative value of contributions. For example: a guaranteed construction contract or a personal guarantee on a loan might equal another 10% share of the proceeds or ownership.
C. UNDERSTANDING THE DEVELOPER CONNECTION

In a joint venture one of the developer's primary motivations is to secure a credit lease that enables him to finance the project and provide a profit after debt service. The developer may also be interested in gaining access to a valuable site, owned by the corporation. While some developers are merchant builders, most are in the business for the long-term benefits of cash flow and appreciation. They prefer to reap the long-term benefits of their efforts. A joint venture can be used as a creative leasing technique to attract a tenant and allow the developer to continue building. By joint venturing a developer gets more than just a lease - he creates the potential for other leases. It is one vehicle for a developer to secure land for development on favorable terms or to attract a potential user to land he has already secured.

Developers became accustomed to joint ventures over the past decade as high, volatile interest rates propelled lenders to seek equity participation as part of their mortgage terms. Borrowers were willing to share the potential profits and appreciation in order to obtain long-term loans at fixed interest rates that were sufficiently low to allow some initial cash-flow from the property. As interest rates declined, lenders became less demanding. Instead of demanding equity participation to offset the risk of volatility, lenders have now gone to shorter-term bullet
loans that call for little or no amortization during the term.2

Developers seeking long-term financing in overbuilt, soft markets need to secure long-term commitments from "blue-chip" credit tenants. Joint ventures with such tenants provide a means to that end. As demonstrated in their relationships with lenders, developers are willing to share in the benefits when the participant can help make a project possible and profitable. The corporate venture partner (in exchange for its credit and commitment to a project) can offset occupancy costs with potential cash inflows, tax shelter and future appreciation of the property. The income stream is the determinant of a property's value and therefore the determinant of the financing terms. In a period when demand is weak, preservation of that income stream is essential for adequate financing as well as maintenance of long-term value.

D. SELECTING A DEVELOPMENT TEAM

Large corporations will certainly be inundated with proposals to form joint ventures - particularly, those with desirable surplus land. In the right situation, the chemistry, the project, and the needs will seemingly fall in place. The corporate manager has a fiduciary duty to exercise due diligence and caution in selecting the best possible mate for each transaction. Attractive partners offer complementary skills and value to the venture. This
section looks at some of the important measures for selecting a partner. Corporations should be careful not to overestimate their partner's strengths.

- **Experience**

  The primary reason for a corporation to consider a joint venture transaction with a developer is to benefit from the developer's experience. It is important that the developer partner have experience in the type of development being considered. Experience in one facet of development (such as commercial office) does not necessarily transfer to another type (such as residential or retail). The experience level sought should compensate for the level of inexperience within the corporation. Confidence is best gained in the board-room by a demonstration that the partner's skills offset the in-house weaknesses.

  To gauge the experience it might be useful to investigate the history of the developer's projects. If the developer is to provide project management or marketing for the development, his track record in either of those should be carefully investigated. It may be useful to spend some time in some of the developer's projects. How well are they managed? Has the marketing effort been successful? Just as important might be an inquiry into the developer's relationship with local contractors, architects and brokers. Have they been paid on time and according to agreement? Does the developer manage the construction process effectively and efficiently?
Experience in Joint Ventures

A development partner who has had previous joint venture dealings will often be easier to deal with because they will be able to anticipate questions and issues key to the joint venturing process. In addition, an experienced joint venture partner will likely be more willing to share pertinent information. Knowledge of partnership accounting and alternative tax treatments relevant for individual partners will substantially improve the performance and information exchange within the venture.3

Financial Stability

Another initial screening mechanism for selecting a development partner is financial strength and stability. Traditional tools of testing financial viability should be used with scrutiny and caution. This may include financial search through industry reports such as Dun and Bradstreet. The extent of the developer's holdings is not necessarily a good gauge. Too often those holdings are quickly built and heavily leveraged. An empire built on heavily leveraged resources can quickly dissipate.4 Even the strongest looking portfolio could be sold or mortgaged in a financial bind, so it is important to evaluate more than the financial status at a single point in time.

Financial ratios, audited financial statements, and credit ratings should be carefully checked from the beginning. The depth of resources is more important than
mere size. There should at least be some capability to contribute to cash shortfalls as a participative partner. The same criteria used by banks in evaluating developers can apply here, namely: credibility, capability, capacity and credit-worthiness.

o Established Track Record

Longevity of the development firm in the development business is good indicia of prudence and sound business judgement.\textsuperscript{5} Given the cyclical nature of the development industry, careful scrutiny of the developer's history in weathering the down-cycles is revealing and informative.

o Scope

The corporate partner would be wise to consider the level and scope of development anticipated before embarking upon selection of a partner. The developer selected should fit the anticipated scope. For example if the only development being considered is a local home-town development, the developer selected should be one who is aware of and sensitive to the political, environmental and construction practices of the locality.

On the other hand, a corporation might consider a large national developer if they are considering several projects across the country. On multiple projects the experience and relationship developed could be easily transferable. However, some national corporations purposely avoid tying themselves to one developer in order to stay clear of
favoritism and/or antitrust implications.

o Prior Dealings

The best way to know and understand the operating principles and practices of an entity is through direct contact. Prior dealings make the gears of progress work more freely. Less time will be spent in positioning and posturing and therefore more time directed towards accomplishing the task after a working relationship has been established.

o Offset the Firm's Weaknesses

A fundamental reason for considering a joint venture approach to development is to gain the synergistic effect of joining dissimilar capabilities. The more the respective skills diverge the greater symmetry will evolve. The boundary to this argument arises where dissimilar skills give rise to conflict.

o Select Equally Experienced Partners

Resource differences give partnerships opportunities for greater combined strength and synergy. But, differences in experience level, management styles, control systems, and outlook are disruptive. Joint ventures are relationships where compatible partners are needed. Fundamental differences in perspective or hidden agendas are some of the most prominent factors in joint venture failure.⁶

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Market Access

Market access is the second most important skill that a developer can bring to the development with speculative space involved (after development expertise). This attribute is most important in the surplus property joint venture scheme. Corporate perspectives are typically financially oriented. Good developers are not only market oriented, but able to capture a substantial portion of the market they target. However, market access in either residential, retail or commercial is most often not interchangeable. Each is a unique market with distinct characteristics. Many successful commercial developers have failed miserably in the residential market and visa versa.

Technology

Technological capabilities become especially important when considering development of unique properties or when the corporate venture partner intends to use specialized or state of the art equipment. One example is the capabilities developed by the Perini Corporation in marine construction, or technologically innovative up-down construction. Their development subsidiary would be well positioned to provide the unique technical skills in a project where such technological skills are needed.

Integrity

Perhaps the most important consideration for the corporate partner interested in maintaining a valued corporate image is the integrity of the developer.
Throughout the development process the name and image of the venture partners will be intrinsically linked. Activities by the developer may often reflect upon or have reverberations towards the corporate partner. The partnership image goes a long way in promoting or detracting from the success of a development. The impact of a partner's blemished reputation could affect more than a singular development project.

Integrity can go far beyond mere image when executing a large and complex real estate transaction. Many times it is necessary to have complete trust in the partner since issues arise that no partnership agreement could ever sufficiently detail.

Communications and Trust

For a development venture to work effectively, an essential ingredient of the partnership is complete communication and trust. These elements were stated as strongly important in every interview with joint-venturers. The development process, by nature, is fraught with unknowns and rapidly changing variables. The partnership that doesn't begin and continue on the basis of trust is doomed for problems. The relationship must start with trust among not only the principals but also the managers and those who will be executing the business plan. Trust will continue to thrive (where it is deserved) best in an environment of open and informative communication.
A partnership venture cannot afford to have one partner withholding information. Successful ventures seem to have continuous flows of information that work as "grease" to the wheels of operation. An operating partner must keep the other continually apprised of the situation and the status of the project whether the information be good or bad.

- Sensitivity to corporate objectives

Early encounters with the developer can provide clues as to eventual dynamics of the partnership relationship. One important measure is the sensitivity demonstrated by the developer to corporate objectives. Are responses dogmatic, imaginative, or boiler plate? Does the developer merely echo concerns or seek to address them responsively? What does the corporate culture prefer in a partner? The company cultures of most development firms will be different from the typical corporate bureaucracy. Nonetheless, a corporate manager's job will be greatly facilitated by the developer who can work well with the sometimes foreign corporate culture.

- Political or local connections

A factor not to be ignored in many communities is the quality of the political ties of the development organization.

- Connections within financial community

Friction with community groups can cause the demise of even the best conceived project. A project that will be
leveraged must have strong financial backing. Contacts with bankers, insurance companies and pension funds will not only be beneficial in the startup phases, but will be needed for refinancing or eventual sale. The corporation should verify the developer's financial contacts.

- Rapport with corporate management

Since an essential ingredient to the successful operation of a joint venture is the support of top management, a developer must have the capabilities that will instill confidence and gender support from within the corporate framework.

- Risk Sharing

Real estate development, particularly in the land development and construction phases is a highly risky enterprise. The corporate user minimizes the risks by agreeing to lease some portion of the developed space. The risk of the remaining speculative space remains to be borne. Corporations may want to shift as much of that risk as possible to the developer partner.

- Development Expertise

The complex nature of most development projects requires a level of experience beyond most corporations present capabilities. Until those skills can be mastered and harnessed within the corporate framework, they should come from outside the organization. Experienced developers have acquired (can offer) skills and abilities in such
diverse areas as:

- zoning and approvals,
- negotiation of architectural and construction contracts,
- management of design and construction,
- marketing sensitivity and marketing capabilities,
- financial acumen and contacts

**Leverage**

An experienced developer is recognized as a force within the development community that will be around for some time. Contractors, architects and suppliers may be more likely to give concessions in order to maintain the repeat business. The developer's leverage is certainly greater than a one-time and infrequent corporate participant.

E. MANAGING THE CORPORATE INTERNAL FACTORS

The importance of selecting a qualified and compatible development partner cannot be overemphasized. Of subsequent importance is managing the internal constraints and conflicts in an effective manner. A number of the constraints and potential problems of negotiating and managing the joint venture have already been discussed. In Chapter Two, Table 2-B outlines the conflicts between real estate and the operations groups. The real estate entity serves a support function, but that does not preclude active management of its corporate mandate. This section describes some negotiations and management techniques for making a joint venture function on the corporate side of the equation.
Plan well, but follow through with management

Thoughtful attention to the planning and creation stage of the joint venture are crucial to its success. Every effort must be made to rally support of all levels within the corporation and to demonstrate the potential rewards of the joint venture effort. At least one key manager must champion the cause throughout its process. Sufficient resources must be secured to allow continued viability of the project. Strategic alliances and top management support must be carefully nurtured. But the joint venture viability doesn't stop there.

A study of joint ventures conducted by Coopers & Lybrand revealed that nearly half the time top management spends on the average joint venture goes into creating it. "Attention to subsequent stages is often scanty. ...Involvement trails off severely as time wears on - to 23% of executive time for developing the plan, 19% to drafting legal documents and 8% to setting up management systems."

The percent of time devoted is perhaps not as important as a recognition that the venture continue to receive managerial attention throughout the development and management process.

Foster trust within the corporate parent

Trust and commitment are essential ingredients to the vitality of any venture. "Trust comes hard at the top. But it comes even harder down the ranks - and that is where the
fate of most alliances is sealed." It is impossible to accurately predict the nature of difficulties a development project may incur. But if trust has been developed and nurtured on all levels, when things go wrong, energies can be focused to the problem rather than the finding fault.

o Winning isn't everything

Successfully running a corporate joint venture program requires a new dimension in management skills. There are many sides that must be answered to and it takes an enormous amount of balancing. Successful joint ventures often require a mindset contrary to most business precepts: Namely that winning isn't everything. One manager stated "If I tried to gain the upper hand in a joint venture, my boss would reprimand me." Once again, there needs to be a balance because the extreme of the mutuality mindset could mean giving away the store.

o Allow autonomy with accountability

The "right" balance of autonomy and accountability needs to be established between the corporate parent and the real estate entity. Every situation will be different, but the following guidelines will suggest ways of managing the relationship with the parent. In most cases the real estate unit's responsibility is to support the operations process of the main business line.

o Clearly define what the parent should expect

There will be a greater chance for smooth operations if
The performance measures are clearly defined and in place from an early stage. The risk and reward tradeoffs should be clearly spelled out. All expectations should be clearly communicated. Few things could be more threatening than for the chief financial officer to discover one morning that the venture's debt obligations have violated the covenants in a corporate bond.

- Maintain constant communication, both good and bad

"Out of sight out of mind" is not the best credo for a joint venture to follow in its relationship with the parent. If managed correctly, the corporate management should be kept fully aware of the progress of the joint venture project at all times. They should also be reminded of the benefits that are being provided now and in the future.

In order for a transaction, as involved and complex as a joint venture in a real estate development, to succeed, it needs the support and blessings of top management and the board of directors. There are a lot of political implications to that fact. The corporate real estate manager has to be confident enough in the venture and secure enough in his position to carry it through. The initial foray into a joint venture will likely take phenomenal amounts of time and energy in order to gain support and put the project together.

One corporate real estate manager spent years convincing corporate management that the idea was sound.
They have since participated in several joint ventures that are proving successful.

o Negotiations

The philosophy espoused by this discussion on negotiations is that joint venture partners should do all they can to raise and resolve issues that may impact the joint venture development process in the early stages of negotiations. Changing circumstances and aspirations of the partners may cause the terms agreed upon to evolve, but the operations will be smoother if all significant contingencies have been considered and addressed.

The entire decision process discussed herein has been oriented towards understanding the interests of the corporation and the most favorable means for achieving corporate objectives. A firm understanding of the corporate interests and objectives is precisely what is needed for an effective negotiation strategy.

The initial bargaining position will likely be formed by a manager's assessment of the firms need to joint venture and the expected benefits of doing so. The next step is to understand the developer's interests and the value of what the partner brings to the negotiation. Who brings what to the table and what is wanted by each side for its contribution is the best way to sum it up. The balance of power will favor the firm that controls the resource most desired.11

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Once the manager understands both side's interests, intended contributions and desired returns, the pie can be expanded beyond what either can do alone. For example, the corporation may need a specific parcel of land and a reservoir for corporate surplus cash, but does not want to impact earnings with tax losses. The developer has the land, needs cash and a tenant to secure financing and needs tax losses to offset a large expected cash flow. An oversimplified example, but it demonstrates how the benefits can be expanded before they are divided. The corporation gives the cash and it's credit tenancy for an equity interest which harbors the cash and reduces effective occupancy cost. They gain the developer's expertise and land. The developer gets the tax losses, the credit tenant and a partnership in safe investment.

Discussion of shared benefits is helpful in arguing for creative solution to problems and a recognition that "winning isn't everything" in a long-term relationship. Pushing too hard for the last buck may result in "winning the battle, but losing the war" when the partner turns the tables next time or walks away from the deal.
CHAPTER FIVE

THE JOINT VENTURE AGREEMENT AND MANAGEMENT PLAN

"The plan means nothing, but planning means everything."

- Anonymous

This section describes some of the issues and principles that must be addressed in the joint venture agreements and subsequent management of the development. It is not a "boiler plate" legal document, but a skeletal description intended to help clarify the major points of consideration. There is no single blueprint applicable to all joint venture agreements or management plans. Most joint venture partners interviewed agree that the venture documents mean little without the total commitment and trust between partners. One operational venture had reduced their entire agreement to twelve written pages.

There are limitations to what can be written into an agreement and the extent to which a contract can ensure joint venture success. "Alliances fail because operating managers do not make them work, not because contracts are poorly written".¹

The joint venture and development agreements will evolve through the initial proposal stages to a formal contract. Prior to and during this process, the purpose and
expected contributions and gains of each party are the touchstones against which partners will compare ongoing operations to ascertain whether the venture meets their respective objectives. The process and methods will vary, but the key is to ensure that every issue and contingency that may affect the relationship is covered by the negotiating parties.

A letter of intent might be drafted in the early stages of the process in order to "capture" the intentions of the parties. Great care should be taken to anticipate any possible changes that may take place in the partners' relationship. Although many such changes are difficult to conceive at the time a relationship is being formed and nurtured - failure to do so may precipitate future disaster. As long as the development is going well, neither partner has much reason to call upon the contract documents but as soon as things start to go awry the documents provide the "battle tools". The corporation who has taken adequate time to anticipate such issues will be better prepared for any difficult times.

A. NECESSARY PROVISIONS

As partners attain an understanding of the venture's mission and the respective objectives of each party it is time to negotiate a contract. The document should reflect a "meeting of the minds" on key issues of the present and future. This section is intended to help the corporate
manager isolate and decide upon the corporate zone of agreement on key issues and reduce it to writing. It is a representative list - not necessarily exhaustive. Most of the issues discussed in this section were raised in discussions with corporate real estate managers. They reflect their key areas of concern.

- Define scope and purpose: By carefully considering and precisely defining the scope of the project, the corporation can avoid future conflicts about their intentions for the development or the end result. This is especially important if the corporation has opted for a limited partnership position. Since limited partners lack the right to participate in management, the definition of the venture's scope in the agreement provides a restraint on the operating partner.

- Term: Assignment of a term for the duration of the venture sets a planning horizon and binds both parties for that term.

- Management: The management authorization describes the degree of discretion that the management partner or team may have. The rights could include: the right to contract, sell, incur indebtedness, or mortgage property belonging to the joint venture. The management section gives a clear description of who has the day-to-day decision rights and to what extent. There should also be recommendations for dealing with decision impasses at different points in the
development process.

- Capital contributions: If the corporation provides the land or a strong credit lease for a substantial portion of the project, the developer may take responsibility for everything else. The developer would, in addition to managing the development process, procure financing. If the developer were the general partner he would also be at risk. Every conceivable alternative or decision could be structured, but the corporation should have a strong understanding of their parameters before beginning negotiations. The agreement should describe the effects of overruns and how they are met, and whether the contributions to meet the overruns are treated as loans or equity. It should also describe results for failure to make contributions.

- Budgets: The venture partners will want to carefully set budgets to be used as bench-marks and to control the development process. The budgeting process will be most helpful to the non-managing (corporate) partner in assessing the performance of the development manager. Some budgets used by joint ventures include:

  - Development budget: estimating total project costs.
  - Operations budget: estimate of receipts and expenditures for management, maintenance, supervision and operation of the project for each fiscal year.
  - Capital budget: estimate of any capital replacements, substitutions or distributions during each fiscal year.

Where possible, the corporate venture partner will
want to seek authorization in advance from the parent for prescribed budgetary discretion so that the process will not get bogged down at some point, in want of approvals that are tied-up in corporate bureaucratic red-tape.

- Major Decisions: Control can also be maintained by the non-managing partner through the use of "major decision points" described in the development agreement, or joint venture agreement. These agreements require approval of both the venturers and include such milestones as:

  - approval of development plan,
  - major change orders,
  - amendment to development agreement,
  - acquiring land or interest therein,
  - financing beyond a preapproved line of credit,
  - selling, transferring or mortgaging property,
  - determining distributions,
  - changes in annual capital budget,
  - agreements with related third parties,
  - naming the project,
  - dilution of percentage interest,
  - architect selection,
  - contractual limitations,
  - removal of operating partner.

- Division of interests: The division of interests issue is handled in every conceivable manner by corporations. The most logical way is to value each partner's contributions of expertise, time, equity, risk reduction, or guarantees, and divide accordingly. Most joint ventures follow a convention of allocating equal ownership interests to each party and weighing the value of contributions in terms of priority distributions. Accounting rules for unconsolidated subsidiaries require ownership of less than 50%.
o Capital Distributions: Additional and initial capital contributions are repaid in the ratio of each venture's contributions, before a distribution of profits is made. The formula for distribution beyond that point is according to the determined value of each venturer's ownership share. Priority distributions may be made for extraordinary contributions such as contribution of land.

o Right of transfer of interests: This section outlines such issues as sale to third-party, and first rights of refusal to purchase another partners interests before a transfer or sale. The co-venturers specify that their respective interests cannot be sold or transferred without specific written permission of the other. After careful selection of the partner by the corporation it would be unwise to let the partner exchange that interest in its sole discretion.

o Allocation of tax benefits: Before negotiations begin, the corporation should know the extent to which tax benefits are attractive to the company. Tax advice should be sought before structuring the agreement to ensure that assumed tax benefits can, in fact, be of benefit to the corporation.

o Financial partner contributions: It is not unusual to find a third-party financial contributor participating as a partner in such a venture. The extent of the financial
partner's contribution and involvement should be well defined. There should be a definite schedule of contributions backed by guarantee or letter of credit.

- Lender Participation in the Venture: In the instance where a sophisticated lender is providing all, or almost all of the development and operating capital, the lender will undoubtedly want a priority in the distributions. The lender may also want an equity position. (Particularly if the lender provided the financing for the land acquisition and wants to capture the appreciation value for its up-front risk.) The issues that must be negotiated at the outset include, 1) the extent of the lender's allowable participation, 2) the percentage of partnership interest that may be granted, 3) the method of reducing the original partners' interests, 4) the priority of the lender's participation in available cash, and 5) the amount of control that will be surrendered to the lender.3

- Ownership: All property in the venture should be deemed owned by the venturer. No venturer, individually shall have any ownership except as tenants in partnership. Each party should waive all rights to actions for dissolution.

- Operating partner's covenant: The corporation may require that the developer partner do the following:

  o prepare all necessary architectural plans, designs, working drawings, specifications, cost analyses, construction schedules, and marketing plans;
o manage all construction efforts;
o make no material changes from the specified, approved development plan without approval of the other partner and conduct activities only with review and written approval of the partner;
o take full sales and marketing responsibility;
o improve the property in accordance with the preapproved plans;
o incur no indebtedness beyond amounts preapproved by the partners.

One corporation's operating covenant had a predevelopment stipulation that minimized the up-front exposure. The corporate joint venture partner would not contribute the land (corporate surplus land) until the developer had done all site, marketing and financial analysis, prepared complete architectural drawings and obtained all approvals. The corporation was therefore able to take a limited partnership (limited liability) position without needing to exert management control. Their influence was set in the beginning and bolstered by the right to approve major changes in the prescribed plan. Additional control measures can be implemented via the lease contract.

Developer fees and overhead: In the event that the developer sets a fee for development or reimbursement of overhead, periodic disbursement periods should be indicated. A clear definition of what constitutes direct costs for overhead should be established. Payments are pegged to predetermined construction and marketing stages.
o Business and financial records: The managing partner or entity should agree to keep complete books and records reflecting all costs and transactions of the venture. Concurrence on the method of accounting should be made beforehand to determine whether it be on the cash or accrual basis. Partners should also agree on the methods of accounting for tax benefits and distributions.

The developer is required to submit detailed books and records of accounts - showing budgeted and actual costs and other pertinent information on a regular basis. Some joint ventures require monthly accounting, others are only quarterly. All records are available for audit and review at any time.

o Dissolution, liquidation or termination: The specific terms and criteria for termination of the venture should be described. Some events which may trigger dissolution include:

- completion of the ventures prescribed purposes;
- passage of the allotted time or life of the venture;
- a material breach of the joint venture agreement;
- mutual agreement of the parties;
- bankruptcy proceedings against one of the partners.

On dissolution the joint venture may still have continuing contracts and obligations to be performed. Until the venture is liquidated or the obligations terminated the agreement should specify the rights and obligations of the parties involved. The nature of the breach may trigger the right in the remaining partner to take possession of all
assets of the venture and it can be agreed that the other party forfeits all further rights to any profit. 5

- Capital accounts: Individual capital accounts should be maintained for each partner. The accounts include each partner's 1) original contributions, 2) additional capital contributions, 3) proportionate share of partnerships profit allocations and be reduced by, 4) distributions and 5) proportionate share of partnership loss allocations. 6
JOINT VENTURE AGREEMENT CAVEATS & QUESTIONS

- Who gets tax benefits?
- Does the corporation pay tax on distributions not received?
- Who is responsible for capital requirements in excess of budget?
- Are capital contributions treated as loans or as equity?
- Do capital contributions entitle the contributor to preferential distribution of earnings?
- What are the penalties for default?
- What are the "buy out" or forfeiture provisions?
- Who is responsible for cost overruns?
- How are management disagreements resolved?
- What are the priorities for cash distributions?
- To what extent can a partner deal with related entities?
- What happens in the event of death, bankruptcy or insanity of participants?
- Who makes sale, financing or leasing decisions?
- What actions can be taken for managing partner's apparent disregard for fiduciary duty?
- What restraints on competition can or should be imposed on the developer?
- How much of the developers time or efforts should be devoted exclusively to this project?
- What are the rights of the corporation to substitute new management?
- How are disputes resolved between co-venturers?
- How and at what point in time is the value of contributed land determined?
- How have the corporations property rights been protected?

The "bottom line" to contract documents is to understand the intended mission of the venture and reflect it in the agreement. 7

B. THE BUSINESS ENTITY

The form that the joint venture business entity will take is a decision that must be made on two levels. The
first level of decision is how to structure the corporate partner's business unit. The business unit can be everything from a department to an unconsolidated subsidiary. The two most apparent means of accomplishing this are through either consolidated or unconsolidated subsidiaries.

Corporations should consider establishing a separate subsidiary realty corporation to serve as the joint venture partner with the developer. A separate entity can protect the parent’s ultimate liability. As an autonomous unit with defined, discretionary, authority this unit can be much more responsive to an entrepreneurial-type development partner. If properly structured, a subsidiary can also keep the venture's debts off the parent's balance sheet.8

A subsidiary is a corporation which is more than fifty percent owned by another company. The parent, or majority owner can effect either policy or day-to-day influence and control over the subsidiary. Generally accepted accounting principles (GAAP) permit the parent organization to account for the subsidiary in one of two ways. The parent can either, 1) combine or "consolidate" the subsidiary's financial statements with its own, or 2) report the investment in the subsidiary using the equity method. In either event, the treatment depends upon the firm's consolidation policy and few accounting rules.

The creation of legally separate subsidiaries reduces
the financial risk to the parent organization. Losses would fall only on the owners and creditors of the subsidiary - the parent doesn't have to legally bear the risk of greater loss. Accounting rules suggest that a subsidiary can be unconsolidated if its operations, 1) differ significantly from those of the parent, 2) if the parent corporation owns less than 50% of the subsidiary, and 3) the primary business of the real estate subsidiary is not leasing facilities to the parent.

For an unconsolidated subsidiary, the equity method of accounting is required and used. In other words, the net of the corporation's original contributions, plus any profits or losses occurring over the life of the venture, is all that need be identified on the balance-sheet. Any financing need only be displayed as a footnote on the parent's financial statement if it is significant to the corporation. Thus, the "off-balance-sheet financing" approach takes the pressures off the unconsolidated subsidiary to produce quarterly earnings and avoid debt. A corporation, through an unconsolidated subsidiary, can enter a partnership with minimal investment and by leveraging, create a major asset without distorting the financial ratios or capacity of the parent.

The next level is to decide whether to be a general or limited partner of the venture. The decision depends primarily upon the amount of liability and management control that the partner wants to have. If a partner wants
minimum exposure and is uninterested in the daily management decisions of the development, then the option will likely be for a limited partnership position. A limited partner, in order to maintain its limited liability status, must stay within the provisions allowed by the Uniform Limited Partnership Act (or its equivalent as adopted within the state of the sites of the partnership). Limited partners who participate in the "control" of the partnership will be regarded as general partners under the provisions of the Act. The most that a limited partner can do under these provisions is:

- require the maintenance and inspection of partnership books;
- demand a formal accounting of partnership affairs;
- loan money to the partnership; and,
- request a dissolution and winding up by court decree.

The participation of most major corporations in development in joint ventures, appears about equally split between limited and general partners. In all cases the agreement has been to allow the developer to manage the development process and in most cases to provide the property management services as well. The developer is the general partner and the corporation, either limited or general.

The primary advantage to a general partnership position is the amount of control that it affords the corporation. Those who have participated as limited partners, in most cases, were confident that sufficient control mechanisms
could be instituted in the development and partnership agreements and in the lease. The one regret of a participant in development of surplus corporate property was that they were not involved enough in daily operations to be learning the business - which they wanted to do. The business unit and the partnership status decisions depend on the policy and discretion of the corporation. Each has impacts on risks and control that must be considered carefully.

C. KEEPING THE MARRIAGE INTACT

This section draws from the experiences of successful joint venture arrangements to suggest a few paradigms for preserving the venture relationship. The discussion assumes that the partner was carefully selected to conform to corporate objectives and criteria. Communication is an essential ingredient to venture success. One partnership made sure that some, at least informal, contact was made between partners weekly. In that case, the entire venture program evolved around a series of plans and regular communication. Monthly progress meetings were held in which the status of the development was reviewed. Quarterly budget reports were generated and the actual progress was reviewed relative to plan and budgets. The budgets were established annually along with the business plans for the coming year. All this operated under the umbrella of the development program and partnership agreement. It sounds overwhelming, but operationally it provides for constant
review and communication of each partner's expectations. Suprises are unlikely to disrupt the venture's progress and changes can be made to reflect the changing expectations of partners.

D. PREPARED FOR DISSOLUTION

To prepare for dissolution or disbanding of a partnership at the time of its creation sometimes seems counter-intuitive to businessmen. If considered at all it is a job "left to the lawyers". However, it is wise to consider the factors of future conditions which may call for separation and prepare accordingly. Breaking up a partnership can, in fact, be vastly more difficult than forming one.

Some of the factors which might be taken into consideration are what to do in case of: 1) dramatic shifts in the nature of the corporation's main business line, 2) mismanagement, fraud or dishonesty by a partner, 3) the developer partner wants out or undergoes substantial reorganization.

In response to these considerations, and others, these suggested approaches to reorganization or dissolution might apply:

- Judicial dissolution in accordance with the requirements and provisions of the Uniform Limited Partnership Act.
- A put option which obligates the other partner to purchase the corporate partner's share at a predetermined price or value formulation.
o A call option permitting dissolution or buy-out of the partner rather than withdrawal.

o A "russian roulette" approach, whereby, either partner has the right to purchase the other partner's interest. An effort to purchase by one partner triggers a right in the offeree to purchase from the offeror at the same price. This approach forces the offeror to make a reasonable first offer.

o A finite term for the joint venture agreement. Since a joint venture is, by its nature, formed to conduct one transaction, rather than an ongoing business the term should always be well-defined.

An agreement governing the potnuptial relationship might seem distasteful to those attempting to form a positive relationship. But situations are forever changing and the likelihood of changed interests in the future is high. Better to prepare for future break up than to be caught in the unhappy circumstance without an avenue for amicable resolution. 9

E. PRIVATELY HELD CORPORATION:

The orientation of most of the discussion in this text has been towards publicly held and traded corporations. Some of the issues and constraints regarding corporate real estate change when a privately-held corporation is involved. Many of the conflicts and internal management concerns that impact real estate decisions in publicly-held corporations dissipate.10 The market pressures of Wall Street, to demonstrate growth in quarterly earnings, are not present in the private firms and so, a longer term perspective is easier taken. Concerns about the cyclical nature of real estate can be tempered when the corporate earnings profile is more patient.

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"Cash-generation is more highly valued by private corporations as are the associated tax benefits of real estate development." If tax shelter is not of importance to the company, there is at least a greater willingness and ability for the private corporation to pass along tax benefits to related entities. Also, real estate tends often to be a means of estate-building for the shareholders of the private firms. Land banking and land development are not unusual pursuits towards that end.

"Real estate acts as an insurance policy that the corporation will survive for years into the future." A prime example of a private corporation who has successfully pursued joint ventures in real estate development is Johnson Wax Corporation. Johnson Wax oversees joint venture development of commercial and residential properties throughout the country. In short, joint venture developments for private corporations can be an advantageous means of smoothing out the day-to-day business of the corporation and providing for long-term value.
CONCLUSION AND SUMMARY OF FINDINGS

The role of corporate-America in real estate development is being revisited. This time increasing attention is being placed on the importance of managing corporate real estate assets and capturing the value lying within them. Previously, several of the largest American corporations got into real estate development as a means of diversification from their primary lines of business. In most cases, their attempts were met with dismal failure and the exodus was swift. Few remain in the business and those who do are typically developing their own surplus assets. The evidence makes it clear that large corporations do not have the knowledge or capabilities to profit from solo efforts in real estate development.

Therefore, Fortune 500 type firms are not now, and are not likely to become, heavily involved in real estate for reasons other than their own direct corporate use. There is now a push for corporations to actively manage the real estate assets that are for their own direct use.

Academics and practitioners agree that corporate real estate assets are under-utilized. The worst examples are those assets that lie dormant for years, sapping the corporate coffers to keep them maintained and the taxes
paid. More frequent are examples of inefficient uses, poor management, and dispositions that yield much less than true value. Add to the mismanagement, the fact that the cost of housing corporate-America has been rising rapidly — in real terms (the cost of occupancy, as a percentage of revenues, doubled during the past decade); and the evidence becomes more clear that corporate real estate is under-utilized.

Corporations have historically faced the corporate real estate issue as either a lease or buy type decision — many still do. Each extreme option has its place and respective benefits. There are many options in-between. A joint venture with an experienced, well-capitalized developer is one option available to corporations that can provide the best of both worlds.

As more attention is coming to announcements of development joint ventures with corporations such as IBM, AT&T, Xerox, and others, more companies are taking notice and giving consideration to the idea. Corporations are getting smarter at looking at their assets and seeking ways to leverage their position or simply manage more effectively.

It is not insignificant that these corporations are assessing and attempting to capture the value of their real estate assets. Those assets represent a staggering dollar value: $1.4 trillion — at least 25% of the total assets of American corporations. Substantial value and profit can be
realized by active management of those assets.

The approach taken by many corporations is to joint venture their projects with experienced, financially sound developers and to take a share in the ownership. The joint venture affords them the benefits of ownership, with less risk, and a net reduction in occupancy costs, as well as a potential for long-term gain. Developers are pursuing joint venture opportunities as a means of unlocking sources of land and capital; and a tool for securing credit tenants. A joint venture can be a viable alternative that allows both developers and corporations to accomplish their respective objectives.

Corporations who recognize the importance of real estate assets under their control face the issue of how to extract that value or utilize it to improve company performance. The analysis presented, herein, suggests that the process of inquiry begin with a thorough assessment of corporate objectives and the current status of corporate properties relative to those objectives.

The advantages recognized during the course of this investigation are that joint ventures offer corporations financial and operational flexibility similar to outright ownership. But they get the benefit of the developer's knowledge and experience. Through a properly structured joint venture a corporation can, 1) reduce occupancy costs and at the same time, build an asset reservoir, 2) capture
the premium value of surplus real estate, or, 3) secure desirable properties for their own use. The venture can be structured using off-balance-sheet financing and the corporation as a limited partner, so that it does not disturb the parent corporation's recording of debt or overall risk posture.

However, for corporations to effectively capture the value of their real estate they must have a strategic plan that proactively anticipates and plans for needs, regularly evaluates alternatives, and manages the process efficiently. A decision model was offered in Chapter Two to help this process function smoothly (see Chapter Two Table 2-A).

The joint venture alternative is a hybrid that synergistically mixes the developer's knowledge and expertise with the corporation's credit, space need, and the profit motive of both. It is not without problem. First, the introduction of a profit motive to the asset management process creates conflict with the operations groups in which the corporate real estate operation is intended to support. Some of the conflicts are outlined in Chapter Two Table 2-B. The solution to the conflict is not easy to resolve. But, it begins with the overt recognition that indeed the real estate function is a support operation. Therefore, the corporate real estate entity's first motive is to provide space and facilities for primary corporate operations. The risks and rewards sought through the joint ventures should
be tailored accordingly.

Beyond the internal operating dilemma lie other criteria for joint venture viability. The joint venture alternative is not advantageous in all cases. Those most likely to gain the benefits of a joint venture fall within three distinct categories:

1) Corporations with blue-chip credit who can consolidate their occupancy needs in premium markets and thereby, capture value of their own tenancy as well as lease extra space to speculative tenants.

2) Corporations with surplus land or facilities that have latent realizable value that can be realized by packaging and developing.

3) Corporations seeking unique or advantageous sites that are owned or controlled by a developer.

Beyond the general corporate profiles, other financial as well as operational characteristics are important in determining viability. These other characteristics are tests of financial strength, operational willingness, and capability to handle the added dimension of a development partner. A constructive review and assessment of corporate characteristics will ameliorate the chances for joint venture success. The conclusions drawn from interviewers and research were used throughout the text to highlight issues and establish corporate characteristics and profiles. The following are highlights of the major findings of this research.
MAJOR FINDINGS

- Corporations, whose primary business is not real estate development related, should not attempt solo development of real estate unless it is strictly for their own use and they have the in-house technical capability to manage it.

- Corporate real estate assets are, as a general rule, under-utilized and mismanaged. Implementation of a corporate real estate asset management program that is performance measured will reduce occupancy costs and provide opportunities for improved profit from the corporate real estate of most large firms.

- One means of reducing occupancy costs and sharing in the upside potential of corporate real estate is to develop, in concert with an experienced, capable, developer some of the real estate used by the corporation. The joint effort has the overall effect of reducing risks and enhancing gains to both participants. The developer gets a lease from a credit tenant and a partner who shares the risks. The corporation gets, a) reduced occupancy costs, b) the developers knowledge and experience, c) more control less risk than owning outright, and e) potential for future profit.

- The primary risks or drawbacks to a joint venture are, 1) conflicts between corporate operational objectives and the development process, 2) difficulties in setting up,
negotiating and managing a partnership relationship with a developer who has conflicting objectives, and 3) risks inherent with any development process, including market risk, financial risk and potential damage to corporate name and image.

- Corporate real estate managers who have had experiences with joint venture developments are overwhelmingly in favor of them. Those with the most favorable experiences had been accorded some form of autonomy within the corporate structure and reported directly to the corporate level. In virtually every case, the real estate entities must still promote their cause within the corporate hierarchy. The primary function of the real estate entity is support to operations groups - profit performance is secondary.

- Corporations who have not experienced joint ventures fall clearly into two categories. The first group has no interest in pursuing joint ventures and can envision no benefit that a developer could provide. Without exception, this response came from manufacturing-oriented organizations who had technical experience for design, engineering and construction within the firm. These manufacturing firms typically build and own their manufacturing facilities and lease marketing facilities. The second group of companies have been recently considering joint venture options either as a result of developer initiated proposals, or because they have heard that "others are doing it".  

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o Relatively few corporations are involved in joint ventures at the present. The entrance of the blue-chip, well-known firms will likely pave the way. With the push on to manage corporate real estate assets more efficiently, and to reduce occupancy costs, there appears to be a trend towards reviewing the asset management procedures of America's companies. Changes are being manifest in the attitudes towards real estate entities. The push is also being made for business schools and real estate programs to assist in training corporate asset managers.

o Most corporations do not have a clear real estate strategy although many do have organized and operating real estate organizations. If any, the strategy of most companies is simply to be responsive to the operations needs of the organization.

o Corporate real estate asset management is gaining increased attention in trade journals and the business press. Some feel that the emphasis will grow stronger in the coming decade. If the concerns and attitudes of corporate real estate executives are any indication of corporate concern, then that will certainly be the case. As real estate asset management gets increased attention, so will alternative approaches to procuring, owning, and using corporate real estate. Joint ventures are but one alternative, that is quickly gaining popularity.
Joint ventures, in general, are gaining popularity and being used more frequently to improve competitive advantages. As corporations become more accustomed to managing cooperative ventures, their acceptance will likely improve. It was observed that those corporations who use development joint ventures most frequently, use them in the operations side of the business as well. Familiarity with the joint venture style of management is bound to facilitate further use.

Perhaps the most key consideration for corporate managers in setting up a joint venture is partner selection. Trust and integrity were the two most often cited qualifications for a development partner. Financial strength, communication and rapport with the corporate environment were just as essential. The selection process is typically handled on a case-by-case basis so the criteria change, depending on the circumstance.

Most corporate executives felt it was important to have some control in the development process. If a limited-partner position were taken in the venture, then control measures were instituted via the partnership agreement and the corporate lease. Most, also, wanted the developer to carry the risk during the development process. IBM takes a general partner position because of its desire for control and awareness that they are likely at risk whether they are legally or not. Other corporations are content with a limited partnership position since the developer is the
operating partner anyway. Some managers required up-front assurances on cost and capital requirements. Most were limited by capital expenditure limits which had to gain approval by the board of directors.

Joint ventures to develop corporate real estate will be used with greater frequency in the coming years. As long as corporations select compatible, committed development partners; effectively scrutinize the project economics; and manage the internal conflicts, the ventures should prove beneficial.

The most noted of those now doing joint venture development have exerted powerful influence in shaping the form of the ventures. The companies are large and influential and capable of getting a lot of what they want. A final concern is that the same "follow the leader" mentality that was exhibited in corporate entry into real estate may take place on a smaller scale with joint ventures. Corporations should proceed with caution and evaluate the risks and rewards in light of each corporation's objectives and constraints, then proceed if the opportunity looks right.

Caution is the by-word for the corporation embarking on its first joint venture. Feasibility studies and analyses must be carefully conducted at every stage. There are drawbacks and risks to joint ventures - primarily due to the introduction of a partner with conflicting objectives and
the risks inherent to any development project. But, by planning carefully, many of the risks of development can be avoided or transferred. The drawbacks of dealing with a partner have to be managed. About the only way to transfer those risks is to be prepared to deal with and manage effectively.

In order to have a viable joint venture development, it must be one that was selected for its relative advantage to other available options. And the development project must be economically sound on its own merits. Perhaps the most important step in the entire process is the selection of a partner in whom the corporate management can have complete trust and confidence.
FOOTNOTES

CHAPTER ONE

1 See bibliography for representative list of literature reviewed.

2 See persons interviewed list.

3 Most of the documentation on corporate experiences in real estate development in this text came from, Robert A. Sigafoos, Corporate Real Estate Development, (Lexington, Massachusetts: Lexington Books, 1976).


5 Telephone interview with Christopher B. Leinberger, President, Robert Charles Lesser & Company, July 16, 1986.


9 Ibid.

10 Ibid., p. 12

11 Ibid., p. 139-182

12 Ibid., p. 183.


15 Ibid., p.


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17 Cesar J. Chekijian, "Corporate Challenge is to Control Occupancy Costs," National Real Estate Investor, p. 50.

CHAPTER TWO


2 Ibid., p. 183-201.


6 See interview list.

7 Robert Kevin Brown, "Fixed Asset Management: Where Do We Go?", National Real Estate Investor, April 1986, p. 44.


17 Ibid., p. 13.


CHAPTER THREE


3 The items listed throughout the tables in this chapter have been taken from all of the sources references, including interviews.

4 Sanford Bog, Jerome Duncan and Philip Friedman, "Joint Venture Strategies and Corporate Innovation", (Cambridge, Massachusetts: Oelgaschler, Gunn and Hain, 1982).


7 Op.Cit., Levine and Byrne, p. 103.


CHAPTER FOUR

1 See interview list.


4 Ibid., p. 21.

5 Ibid., p. 21.


7 Information gained from Urban Land Institute (ULI) Seminar on "Industrial Real Estate Strategies", April 1986, Washington, D.C.


9 Ibid., p. 104.

10 Ibid., p. 103.


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2 Ibid., p. 55.

3 Ibid., p. 179.

4 Jim Moore, "Corporate Real Estate Activity: Flexibility, Fleetness Will Be Key to Success", National Real Estate Investor, March 1985, p. 45.


6 Ibid., p. 525-562.

7 Ibid., p. 525-562.

8 The discussion on corporate subsidiaries was taken in large part from: Bruce N. Wardrep, Ph.D., "A Pilot Study: Unconsolidated Subsidiaries for Real Estate Holdings", 145

10 The discussion of privately held corporate interests was drawn from: Christopher B. Leinberger, "Private Firms and Real Estate Can Be Symbiotic", National Real Estate Investor, April 1985, p. 40.

11 Ibid., p. 41.

12 Ibid., p. 42.
PERSONS INTERVIEWED

W.C. Bartow, Director, Real Estate, Raytheon, June 24, 1986

Michael A. Bell, President, The Harbinger Group/Xerox Corporation, July 18, 1986

Eric V. Benson, Senior Manager, Corporate Real Estate, Polaroid, July 16, 1986

John Biddle, Manager Facilities Planning, Norton Company, July 15, 1986

Paul Donnelley, Corporate Real Estate, Data General, July 7, 1986

John Dyer, Vice President, Finance & Administration, Upland Industries/Union Pacific, July 30, 1986

David D. Fitch, Vice President, Cadillac Fairview Urban Development Inc., June 25, 1986

Larry Goldberg, Corporate Real Estate, Polaroid, July 16, 1986

C. Lincoln Jewett, Executive Vice President, Security Pacific Realty Advisory Services, June 24, 1986

Christopher B. Leinberger, President, Robert Charles Lesser & Company, July 16, 1986

Ralph Maffei, Director of Corporate Real Estate, Wang Laboratories Inc., July 23, 1986

Kevin M. Mahoney, Principal, Copley Real Estate Advisors, June 13, 1986

Linda Maier, Director Corporate Services, Lotus Development Corporation, July 10, 1986

Caroline McBride, Director of Real Estate Development, IBM, August 1, 1986

John J. McWeeney, Vice President-Real Estate, Stop & Shop, July 11, 1986

Ed Reiss, Manager of Real Estate, Digital Equipment Corporation, July 11, 1986

Gary J. Salton, Vice President, Homart Development Company, July 18, 1986

Bruce Schick, Real Estate Manager, Wang Laboratories Inc., July 23, 1986
Robert Shortsleeve, Director Corporate Services, Prime Computer, July 18, 1986

Thomas A. Steele, President & CEO, Perini Land and Development, June 12, 1986

Barry Thomas, Treasurer, Union Pacific Corporation, July 29, 1986

Tom Trolley, Retired Vice President, Xerox Corporation, July 29, 1986

Ron Voth, Director of Real Estate, Apple Computers, July 12, 1986
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