



# AFIRE News

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## Real Estate Joint Ventures with Islamic Investors: Understanding the Keys to a Successful Relationship

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Since the reversal of the fantastic US bull market run in the spring of 2000, real estate professionals have witnessed a worldwide shift in investor sentiment in favor of cash flowing real estate investments. This trend is best evidenced through the exponential increase in cross-border real estate demand and activity. Multiple sources of capital— institutional investors, high net worth individuals, retail investors and fund sponsors – including organizations which pool real estate investment capital from many individuals or smaller institutions are looking for real estate opportunities in the US and Europe.

The surge in foreign investment in US real estate has been dramatic – 2002 volume was up 356 percent over 2001 and indications are that 2003's volume will be even greater, with year over year volume as of March 31, 2003 up 34 percent over the same period of 2002. Nowhere has the increase in foreign investor demand been more striking than in the capital influx from Middle Eastern investors. Furthermore, the increase in Middle Eastern investment capital for US real estate is being driven largely by Islamic investors- i.e., individuals or entities investing in accordance with the principles of Islamic law (also referred to as *Shari'a*). Sponsors of Islamic real estate funds have indicated that this increased level of investment appetite is likely to continue in the near term. As an asset class, Islamic investors view real estate as a vehicle that will allow them to earn a risk adjusted yield premium relative to the available alternatives. This outlook, coupled with a projected fifteen percent annual growth rate in the Islamic investment universe's demand for real estate and an increasingly positive view of the dollar's prospects for appreciation against the euro, make a strong case for US real estate owners/operators and investment professionals to take some time to understand the fundamentals in working with this increasingly important investor base.



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### **The Preference for Joint Ventures**

Islamic investors have frequently chosen to invest in joint ventures along side established real estate owners/operators, rather than owning 100 percent of real estate assets. There are many advantages to the foreign investor in pursuing this strategy:

1. the investor gets the opportunity to leverage the experience and contacts of a local operator's management team, operating infrastructure and knowledge base;
2. the investor may require its joint venture partner to make a meaningful equity co-investment, assuring an alignment of interests (a) between owners and (b) between ownership and property management;
3. the investor can avoid adding to its overhead burden for administration of the investments by relying on its joint venture partner's personnel to carry out the monitoring, reporting and other administrative functions; and
4. partnering with a well-known operator may provide the investor with name-brand recognition that immediately increases its own credibility in the international real estate arena and augments the likelihood of success for any retail syndication of its investment.

For the US real estate owners/operators there are also many benefits to a joint venture with an Islamic investor, however, there needs to be a concerted effort by both parties to clearly understand each others'

objectives and constraints. The following sections outline potential issues that may arise in a joint venture relationship and ways that some of these issues may be mitigated.

### **Permitted Tenancies**

Perhaps the most fundamental aspect of a *Shari'a* compliant real estate investment is that the owned property or properties must be leased to tenants that are not engaged in prohibited activities. These activities include banking, mortgage lending and consumer lending (including brokerage firms that extend credit to clients); insurance; manufacturing and distributing alcoholic beverages (including restaurants and retailers that serve/sell alcohol); producing and distributing pork related products (including restaurants and retailers that serve/sell pork); manufacturing of firearms and munitions; purveyors of pornography and profanity; gambling and gaming; and tobacco and related products.

While this list may seem limiting at first, there are asset classes which readily satisfy these tenancy restrictions - multifamily and self-storage are two examples. Other asset classes can also satisfy the tenancy tests, provided that care is taken in tenant screening. These include industrial, office, and retail properties with non-prohibited uses. A simple rule for minimizing the potential for conflicts, as it relates to leasing vacant space, is to focus on properties with a single *Shari'a*-compliant tenant, or very few such tenants, with lease terms that exceed the anticipated life of

the venture. By minimizing the anticipated lease rollover, the partnership can avoid the tension that can be created when the operating partner brings a non-compliant tenant (e.g., a highly rated financial institution) to its Islamic partner to fill a vacant space in a joint venture property. Clear communication regarding the tenancy limitations adopted by a particular Islamic investor, at the earliest opportunity, will also assist in avoiding misunderstanding or frustration later on.

### **Financing**

After finding a property that meets *Shari'a* standards, the next most important concern in forming a compliant real estate joint venture is to structure financing that satisfies Islamic principles. A prospective partner with an Islamic investor must bear in mind that such an investor cannot borrow funds through conventional means or pay interest to a conventional lender. There exists, however, a widely accepted body of Islamic Finance that can readily create for the joint venture partners the same financing attributes (in terms of loan to value, financing cost, loan assumability, etc.) that can be achieved through a conventional financing.

The most common Islamic Finance structure utilized in the context of property financing is the "*Ijara*" or Lease structure. In an effort to gain the benefits of conventional leverage while adhering to the prohibition on interest, the title to the real property (the "Property") to be acquired by an Islamic investor in a joint venture relationship is held by an orphan entity or special purpose ownership vehicle (the

"SPV"), which is owned and controlled by a corporate service company. The SPV is the borrower under the financing, and as a lessor (the "Lessor"), leases the Property to a newly formed entity, which is owned by the Islamic investor and its joint venture partner, together (the "Lessee") pursuant to a lease co-terminus with the financing (the "Lease").

By virtue of the Lease, the Lessee becomes the economic owner of the Property, and is acknowledged as such in the lease documentation. The Lease requires that the Lessee make an initial payment under the Lease, equal to a percentage of the acquisition price not funded by third party financing, which allows the SPV to pay a portion of the purchase price and serves as the initial equity in the Property. The Lease provides for on-going monthly lease payments in amounts equal to the interest payments associated with the financing and other negotiated expenses of the SPV, which payments are pledged to the financing provider. Under the Lease, the Lessee receives a call option and the SPV receives a put option with respect to the Property, at an acquisition price equal to the outstanding financing amount. The put right may be exercised by the SPV at the maturity of the financing or upon an event of default. The Lease, including the Lessee's purchase option thereunder, is subject and subordinate to a first mortgage lien on the Property. The SPV collaterally consigns to the financing provider all of the collateral that has been assigned to it by the Lessee as security for the Lessee's obligations under the Lease, including an assignment of the underlying end user leases and rents. Additionally, the SPV assigns its put right

to the financing provider as further security for the financing.

Today, the Lease structure and its variants are widely accepted by a host of institutions including Fannie Mae, Freddie Mac, portfolio and securitization lenders, insurance companies and dedicated mezzanine lenders as a bona-fide means of property financing, and have been endorsed by the major credit rating agencies. While there had been an initial inclination to charge a structural premium for the financing, a growing awareness and increased competition within the financial community has resulted in the incremental costs being limited to minimal additional legal documentation and entity formation expenses. Despite a widespread acceptance of the Lease structure, it is important to note that putting an Islamic financing in place with an institution familiar with the structure is significantly less cumbersome than pursuing such a transaction with an institution unfamiliar with the concept. Likewise, assuming an existing financing in the context of an acquisition is generally an arduous process, particularly in cases where lenders and servicers do not have prior exposure to the *Ijara* structure and experience in dealing with Islamic investors.

From the perspective of a US real estate owner/operator looking to enter into a joint venture relationship with an Islamic investor, there are additional implications pertaining to the financing that are important to understand in an effort to avoid later issues. An example is the Islamic investor's need to distance itself from traditional borrowing in light of the prohibition on interest. Islamic

investors are not in a position to sign financing term sheets and commitment letters; however, they are able to sign a letter of acknowledgement to the potential partner assuming the obligation for their pro-rata share of any transaction related expenses in the context of the *Ijara* agreement. Likewise, Islamic investors cannot be party to non-recourse carve out obligations associated with the financing; the direct burden of these obligations is on the joint venture partner who can, under certain circumstances, be indemnified or otherwise compensated. Additionally, the prohibition on interest necessitates the use of either non-interest bearing accounts for all joint venture related activity or the investment in *Shari'a* compliant Murabahah Funds, which are short term liquidity management vehicles utilized by Islamic investors, now being offered through the Islamic finance subsidiaries of certain global financial institutions.

#### **USA Patriot Act and OFAC Lists**

Due to the enactment of Title III of the Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism ("USA Patriot Act") on October 26, 2001, and money laundering lists maintained by the Office of Foreign Assets Control ("OFAC") of the United States Department of the Treasury, foreign investors in general, and Islamic investors in particular, have come under increased scrutiny when conducting business in the US. Though a majority of Islamic investors conduct their US based investment activity through holding companies incorporated in tax efficient



jurisdictions such as the Cayman Islands, US based joint venture partners and financing providers have an affirmative know-your-customer (“KYC”) obligation, which extends beyond the holding companies to the ultimate beneficial ownership. This obligation is further complicated by the fact that a number of Islamic investors syndicate their investments either prior to, or shortly after, closing a transaction.

Fortunately, both potential joint venture partners and financing providers can mitigate related concerns by conducting business with reputable Islamic investors supervised by regulatory agencies that have established procedures for due diligence that are comparable to the requirements of the USA Patriot Act. Generally, US partners, financing providers and the rating agencies will accept certification attesting to the initial and on-going compliance with the USA Patriot Act and OFAC lists from a regulated Islamic institution as the placement agent and responsible intermediary for an investment syndicated to multiple Islamic investors. This certification satisfies the intent of the USA Patriot Act and reduces what might otherwise become a prohibitive burden on the Islamic investor, its US partner and the financing provider.

### **Public Company Partners**

Islamic investors frequently seek joint venture relationships with US public company (i.e., REIT) partners. Having a public joint venture partner provides the investor with the additional benefit of doing business with an entity that is

subject to several levels of external scrutiny and oversight: (1) stock exchange regulators, (2) auditors (frequently Big 4); (3) equity analysts; (4) credit committees at its leading lending relationships; and (5) in many cases, credit rating agencies.

Despite these benefits, a US REIT partner will need to provide an Islamic investor with comfort on several important issues, unique to public real estate companies, relating primarily to compatibility and alignment of interests. In particular, the US partner should carefully review with the Islamic investor its previous experience in joint venture relationships with capital partners. In addition to discussing this experience from an economic perspective (how actual returns compared to projections, etc.) the US public company partner should provide examples of how it may have altered a business practice or company custom to accommodate the specific needs of its partner – in this way demonstrating its flexibility in meeting the Islamic investor’s somewhat unique requirements.

Also important to address is the REIT’s ability to satisfy the Islamic investor’s holding period requirements. Generally speaking, funds formed by Islamic Fund sponsors have a finite life of between five and seven years, with a strong expectation that the Fund’s affairs will be wound up and investors’ capital will be returned within that stated time period. REITs, on the other hand, can face several important impediments to sale that an Islamic investor will need to receive comfort on: 1) REITs go through periods (like recent quarters) where reinvestment

opportunities are scarce and REITs resist selling properties to avoid potential earnings dilution; 2) REIT partners may not be anxious to dispose of assets that they believe are “core” to their presence in a market or which justify the existence of a regional or local office; and 3) REIT partners may be hesitant to sell when doing so will likely require giving up lucrative property management and leasing contracts on the assets. Assurances of a REIT management team’s willingness to periodically evaluate sales of joint venture assets, coupled with a demonstrated history of pruning the REIT’s own portfolio, can be helpful in assuaging investor concerns. Frequently, however, a well-defined exit mechanism, controlled by the investor, is the only way to satisfy investor concerns. A compromise position on control over timing of sales may involve providing the REIT partner with an acquisition window towards the end of the joint venture’s intended life. During this window, the REIT may have a preemptive right to acquire the joint venture assets subject to investor protections in the form of market value and minimum return threshold tests.

#### **Bridging the Time Zone Gap**

US owners of real estate often voice concern regarding the ability of a joint venture partner located 14 hours away by plane and between seven and eight hours apart in time zones, to be sufficiently responsive on partnership matters. Most frequently, this responsiveness issue is relevant when addressing the resolution of major decisions – e.g., active

negotiations with a major tenant, a lender on a refinancing, a new joint venture acquisition or an asset disposition. While it is true that time zone differences and physical distance can be inconvenient, advanced planning and consideration from both parties should prevent serious conflicts. Successful partnerships generally foresee tenant leasing issues and refinancing opportunities well in advance and can establish guidelines that allow the operating partner to conduct business on behalf of the joint venture, with minimal day-to-day input from the capital partner. Similarly, negotiations over an asset disposition can be left to the operating partner so long as the joint venture has spent time in advance agreeing upon an acceptable form of contract, establishing a range of pricing and timing for sale that is satisfactory to the partners.

Similar strategies have proven effective as it relates to acquisitions in which the operating partner is charged with responsibility for sourcing acquisitions that fall within certain pre-established criteria. The operating partner provides the capital partner with periodic updates in the form of an acquisition pipeline report that discusses in detail the size, material terms and timing of transactions being pursued and provides the capital partner with feedback on transactions that were either lost or abandoned prior to consummation. These reports provide a good framework for weekly or semi-weekly discussion (depending upon how active the acquisition program is) so that each party feels informed and knowledgeable



about the opinions and preferences of the other. The ability to respond quickly to partnership issues is greatly enhanced by physical and time zone proximity. It is frequently comforting to the US partner to know that there is an investor representative within the country available for face to face meetings with financing providers, property sellers, brokers, lawyers, accountants, etc. as business needs may dictate.

### **Conclusion**

To be successful, a joint venture relationship between an Islamic investor and a US real estate owner must be based on a deep and thoughtful understanding of each partner's needs. Both parties to the transaction should develop a general understanding of the counterparties' practices in order to establish a framework in which the partnership can effectively operate. US owners that are considering joining with an Islamic investor would benefit from spending some time considering the issues identified in this article. ★

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