MORAIS LEITÃO
GALVÃO TELES, SOARES DA SILVA & ASSOCIADOS

FORWARD FUNDING AND PURCHASE AGREEMENTS IN THE EVOLVING IBERIAN REAL ESTATE MARKET

by: José Maria Tojal | Associate
Inês Meneses Lampreia | Trainee

Outlook Over the Iberian Real Estate Market

The Iberian real estate market has faced several challenges in 2023, marked by economic downturns, (geo)political instability, and regulatory changes. These factors, among others, have contributed to a volatile market environment, with rising interest rates making it more difficult to finance real estate transactions, which are now more complex and expensive. Developers, reliant on bank financing, have faced higher borrowing costs, leading to a more conservative approach.

Despite these challenges, it is expected that the real estate market will regain momentum in the second half of 2024, with major transactions to occur both in Portugal and Spain. To capitalize on these emerging opportunities and navigate uncertain waters, structuring deals effectively, by aligning the different interest of the parties, both financially and legally, becomes paramount. This is where Forward Funding Agreements (FFAs) and Forward Purchase Agreements (FPAs) enter the picture.

Alternative Financing Solutions: FFAs and FPAs

As traditional financing becomes more challenging, contractual solutions that offer a viable solution to fund large-scale projects, like FFAs and FPAs, are becoming more popular among real estate players. In the past years, we have assisted to a growing interest, by both developers and investors, of these contractual figures on real estate transactions.

Both FFAs and FPAs are atypical contractual figures, that are not expressly regulated under Portuguese law, through which the seller (or developer) undertakes to develop a certain project and deliver it, on a turn-key basis, to the purchaser (or investor). The main difference between both, as better detailed below, lies in the moment of payment of the price due, which may also impact the moment of transfer of ownership over the property where the project will be developed.

Forward Funding Agreement: a Symbiosis of Risk and Reward

In FFAs, ownership of the property is typically transferred prior to the completion of the construction works, notably upon the completion of certain conditions precedent, such as obtaining the relevant licenses to initiate the development. The developer agrees to develop a project according to pre-determined set of specifications and deliver it to the purchaser-investor upon completion but given that the investor is on board at an early stage, it is also able to tailor the development and remain involved throughout the development process.

In return, the investor assumes a significant financing undertaking, typically starting with an initial payment– often corresponding to the purchase price of the land –, followed by periodic installments, to be paid during the development phase of the project. In addition to those payments, and further down the line, the price formula typically encompasses an earn-out, that corresponds to the margin of the seller-developer, as a result of the project's development which is typically linked to the project's operational results. A return on the advance payments by the purchaser-investor may also be agreed through an interest coupon on all sums drawn.

These agreements provide compelling advantages for both developers and investors.

On the one hand, developers gain access to project financing, potentially reducing or eliminating reliance on external sources of investments (notably, some FFAs even restrict the seller from seeking additional funds from third parties). Furthermore, FFAs provide the developer with a guaranteed exit, along with predictability and secure margins for the project's development even before the project starts, thereby reducing development and marketing risk.

On the other hand, being involved from the project's inception enables the investors to influence the projects' development to meet their needs and potentially achieve higher returns. On the downside, this deeper involvement is encumbered with a greater exposure to risk if the developer does not perform or becomes insolvent. Consequently, the parties need to contractually agree on the procedures and risks' distribution throughout the construction phase, meaning that FFAs require more complex transaction documentation, including appropriate protection mechanisms, such as guarantees to address notably, potential developer's insolvency risks.

Forward Purchase Agreement: streamlined process, mitigated risk

Unlike FFAs, in a FPA the transfer of ownership over the property is conditioned to the (i) completion of the project (namely to the construction works and obtaining the necessary operation licenses); and (ii) payment of the final price. Therefore, even though the object of the transaction is still a real estate property (even if indirectly through the acquisition of the shares of the property holding company) that is not yet developed and where the developer also undertakes to build in accordance with the characteristics jointly agreed with the investor, the transfer of ownership only takes place after the construction works are completed, which means the investor is shield, avoiding bearing the construction risk and the developer's risk of insolvency. This results in a simpler purchase agreement with less need for detailed project oversight and risk allocation throughout the development.

While the final price is typically paid upon completion of the works with the simultaneous transfer of ownership, the investor may make advance payments to the developer during the construction phase. However, unlike FFAs, these payments are not progress-linked installments aiming to finance the development of the project, they are payments whose fundamental purpose is to work as security to discourage the investor from failing to fulfil his obligation to pay the final price, rather than to reimburse the developer for the costs incurred with the work. For this reason, in this type of agreements, the developer will typically continue to need external financing, although the fact that the project has already secured a purchaser will make it easier to obtain this financing.

Conclusion

While the Iberian real estate market has faced numerous challenges, such as rising interest rates and economic volatility, the outlook for the year 2024 remains optimistic. To seize the emerging opportunities, both FFAs and FPAs provide strategic advantages depending on the specific needs and risk tolerance of the parties involved. As the Iberian real estate market evolves, leveraging these contractual tools will be essential for capitalizing on the growth opportunities of the different real estate sectors. Investors and developers alike should remain adaptable and well-informed to navigate the complexities of this dynamic market.