STANFORD BUSINESS GRADUATE SCHOOL OF

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WHITE SQUARE: A PERFECT STORM IN MOSCOW

Sometimes it is necessary to be lonely in order to prove that you are right.

—Vladimir Putin, President of Russia.[1]

It was early 2009, and Brian Patterson sat crestfallen in his Moscow office as the world economy unraveled in the wake of the global financial crisis ("GFC"). He was under heavy pressure from KremlinCo, his local Russian partner, to sell White Square as soon as possible.

White Square was a premier office project that Patterson's firm, BIG/Lincoln, was developing in Moscow (see **Exhibit 1**). After six years, the development was nearing completion. However, KremlinCo was reeling and needed liquidity. A sale, if consummated, would monetize the project's $100 million of invested equity – plus a small profit. An immensely dispiriting outcome to Patterson, this was a fraction of the over $475 million in profit that looked so achievable only a short time earlier. If Patterson pressed on, the project faced a risky future and the real possibility of a loss of his partners' $100 million of equity (including land that KremlinCo had contributed).

In the midst of his angst, Patterson tried to comprehend how things had gone so wrong for White Square. Until very recently, the 76,000 square-meter project (818,000 square feet) had all the right elements—a premier location, world-class tenants, a well-capitalized investor, financing from a top-tier German bank, the most experienced contractor in Moscow, and a reputable local partner. Just a few months earlier, the pro forma reflected a jaw-dropping $475 million profit on $315 million in total project costs.

Patterson's dilemma comprised two very different types of challenges: 1) managing the project-level problems that were expected for a development of this size and complexity, and 2) perhaps more vexing, navigating among the divergent interests of his capital partners.

[1] Simon Shuster, "The World According to Vladimir Putin," *Time*, September 16, 2013, http://content.time.com/time/subscriber/article/0,33009,2151148-7,00.html (September 30, 2018).

Cody Evans (MBA '19), Brian Patterson (MBA '89), Lecturer Chris Mahowald (MBA '89) and Charles Hartline prepared this case as the basis for class discussion rather than to illustrate either effective or ineffective handling of an administrative situation.

Project Development Problems

Patterson's problems were numerous. Construction was behind schedule and the contractor was demanding a massive $40 million price increase—the result of the contractor mismanaging its own contractual risk and getting jammed by the local concrete supplier. The anchor tenant only wanted half its lease square footage amid a once white-hot Moscow office market that was now in free fall. And the project's German lender was looking for a reason to call its loan and exit Russia. Patterson couldn't escape the ominous macroeconomic headlines from around the world: Yes, the sky was falling. He was facing an uphill battle, even by the exacting burdens expected of a developer. If he couldn't solve these problems, he would simply have to sell.

Divergent Interests Among the Partners

While Patterson was busy addressing project-level problems, KremlinCo had dredged up a purchase offer from a Kazakh buyer for invested cost ($100 million) plus $25 million of profit. On the heels of a pro forma that reflected a project value of $790 million and profit of $475 million, this would mean abandoning an extraordinary potential return.

When White Square was originally conceived back in 2004, Patterson had convinced KremlinCo to contribute the land for a one-third ownership interest in the project. This simplified the negotiation over land value and oriented KremlinCo's focus toward the ultimate value of the project by partnering with BIG/Lincoln—a firm with development expertise and deep-pocketed financial backing. The principal of KremlinCo also had important relationships in Moscow. As an outsider, Patterson felt these relationships were critical to his success as the developer.

Separately, Patterson's capital partner, BIG Life, was grappling with its own GFC-related financial problems. The sale to the Kazakh investor would return a modest profit alongside BIG Life's $62 million of cash equity invested in White Square and would help shore up its own rapidly deteriorating balance sheet. Valuations across BIG Life's global portfolio were plummeting, and there was no telling when the bleeding would stop. But the old axiom remained true—cash was king—and BIG Life knew it would take more of it to work through the GFC.

Patterson, on the other hand, was heavily incentivized to proceed. Although he had not invested cash in the deal, Patterson had committed to fund up to $40 million in project cost overruns if necessary and therefore had something to lose. But with a healthy share of the profits, he stood to make a sizeable personal fortune based on the pro forma of just a few months ago.

After many years of laying the groundwork for the project and establishing his reputation as a developer in Russia, Patterson found the thought of giving up now nauseating. However, he had a fiduciary responsibility to act in the best interests of his partners. How could he balance these competing interests while keeping his own vision alive after six long years of work? (See **Exhibit 2** for a timeline of the White Square development project.)

FROM TEXAS TO RUSSIA

Patterson, a country boy from Texas, had moved to Warsaw in 1992 as a recent Stanford GSB graduate to pursue adventure and to set up his own property development company. By 2001, he was running BIG/Lincoln, a Warsaw-based real estate company that was developing projects to capitalize on the rapid growth in Central and Eastern European markets after the fall of the Soviet Union. He was currently building five projects across Poland at a total cost of over $250 million.

BIG/Lincoln was a joint venture ("JV") between Patterson, BIG Life and Lincoln Property Company (see **Exhibit 3** for an overview of the partnership structure). BIG Life, a New York-based global insurance company with $30 billion invested in real estate, was the "money partner." BIG Life was active in 50 countries and expanding. Lincoln Property Company, a real estate developer based in Dallas, was one of the largest real estate firms in the United States, with projects across North America and Europe. Lincoln was the "development partner" for the BIG/Lincoln JV, which was led by Patterson. The combination of Patterson and two premier firms made a strong team emerging market development team.

More than a decade after the fall of communism, the Russian economy was growing rapidly, and the country welcomed foreign investors. While the 1998 Russian financial crisis had dealt a major setback to the economy, BIG Life reasoned that by 2001 the worst was behind them (see **Exhibits 4** and **5**). While there were still major challenges to doing business in Russia, BIG Life sensed opportunity and asked Lincoln and Patterson to expand BIG/Lincoln's footprint there.

Finding a Partner

BIG/Lincoln's first order of business was to find a Russian development partner to navigate local rules, regulations, and laws—which could be idiosyncratic and difficult for outsiders to understand. Moscow was new territory to Patterson, and he knew he needed a local on his side to avoid the plague of costly mistakes that often afflict investors entering a new market. A deep-pocketed capital source like BIG Life and an experienced developer like Lincoln made for an appealing combination to prospective local partners. After a thorough courting process, BIG/Lincoln settled on KremlinCo, a Russian metals and mining conglomerate that had deep relationships in government and previous real estate experience. Adding to its allure, KremlinCo owned some land that seemed like an ideal site for development. Patterson valued KremlinCo's size and government connections—attributes he believed would be helpful for future projects. In January 2004, BIG/Lincoln and KremlinCo drafted a business plan and a development agreement. The nascent partnership began working on the development of its first venture—a three-building office complex that would come to be known as White Square.

A 'White' Hot Market

Launching the development of White Square in late 2004 seemed opportune. Russia had six years of strong economic growth under its belt, an investment-grade sovereign debt rating, and it was pursuing membership in the WTO.[2] Although Moscow had a dearth of sophisticated real estate developers, industry analysts were comparing its real estate market to London and Paris, the most prominent markets in Europe. A study in *Emerging Trends in Real Estate* ranked Moscow the best market on the continent.[3] And it was a landlord's market: There were so few quality office buildings that the existing stock was subject to competition among tenants seeking space. Furthermore, because the design and permitting process in Russia typically took about three years, developers like BIG/Lincoln knew there was a paucity of new supply coming to market.

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[2] The mission of the WTO, or World Trade Organization, was to "ensure that trade flows smoothly, predictably and freely as possible." See the WTO website, https://www.wto.org/english/thewto_e/whAtis_e/inbrief_e/inbr00_e.htm (October 1, 2018).

[3] *Emerging Trends in Real Estate Europe 2004*, The Urban Land Institute and PricewaterhouseCoopers LLP, 2004, http://test-americas.uli.org/wp-content/uploads/sites/125/ULI-Documents/EmergingTrendsUS2004.pdf (October 16, 2018).

By 2006, White Square's design and permitting was completed, after just two years. Among projects of this size and complexity, it was the fastest to navigate the byzantine Moscow permitting process—something that helped convince Patterson that KremlinCo was the right local partner choice.

Given the shortage of quality office space and Russia's economic growth, Class A office market vacancy was only three percent, and rents were rising rapidly. BIG/Lincoln's original rent assumptions from the 2004 pro forma of $500 per square meter ("$m^2$") per year were now below current market rental rates of $650 per m^2 just two years later. Including other revenue, the project's 2004 pro forma annual net operating income ("NOI") was $42 million (weighted average rent of $554 per m^2). Based on projected all-in development costs of $230 million, or $3,000 per m^2, this would result in a generous 18.3 percent unleveraged development yield on cost.[4]

Initial Development Pro Forma (as of 12/31/2004)			
	Net Rentable Area (sq. m)	**$ / m2 / Year**	**NOI / Year**
Office	70,000	$ 500	$ 35,000,000
Retail	6,000	$ 850	$ 5,100,000
Total (excl. Parking)	**76,000**	**$ 528**	**$ 40,100,000**
Parking spaces	820	$ 2,400	$ 1,968,000
Total (incl. Parking)		**$ 554**	**$ 42,068,000**
Development Cost			$ 230,000,000
Memo: Development Yield			*18.3%*

Source: Compiled by the authors.

For most of the twentieth century, new development in communist Moscow consisted of drab buildings that emphasized function over form. Modern Class A office buildings were rare but nonetheless still traded at high cap rates of over 12 percent.[5] By building to an 18.3 percent yield on cost in a 12 percent cap rate market, White Square was being constructed at a development premium (or 'markup') of over 50 percent. Patterson knew this was an enviable position; his peers in the United States and other more mature markets were building to a 15 to 25 percent markup. However, this large markup reflected the many risks inherent in a development project in an emerging market: currency fluctuations, political uncertainty, market instability, fluid regulatory environments, limited financing alternatives, and unstable economic conditions.

Based on Russia's improving economy and the anticipated credit quality of the tenants that a premier project like White Square would attract, BIG/Lincoln believed it might command a market-leading cap rate upon sale of up to 10 percent. With $42 million in NOI, this would equate to a $421 million value—an eye-popping profit of $191 million.

Cap Rate Improvement from 12% to 10%						
	Annual NOI	**Cap Rate /**	**Value**	**Development Cost**	**Profit**	**Profit Margin**
Initial Pro Forma	$ 42,068,000	12.0%	$ 350,566,667	$ 230,000,000	$ 120,566,667	52.4%
Improved Cap Rate	$ 42,068,000	10.0%	$ 420,680,000	$ 230,000,000	$ 190,680,000	82.9%

Source: Compiled by the authors.

[4] The difference between the yield on cost and the cap rate is the development spread. The development spread represents the profit margin between what a project cost to build and its as-built value at prevailing market rates.

[5] In developed markets, cap rates are often in the mid-single digits for Class A office buildings. However, in emerging markets, like Russia, cap rates are higher reflecting the numerous additional risks borne by investors.

Construction Begins

BIG/Lincoln wanted to build to its typical world-class standards. Meanwhile, KremlinCo had only known poor building standards and had never seen a hot real estate market. Jittery that the market might evaporate overnight, KremlinCo was restless during the design process. These contrasting philosophies created nascent tension.

By early 2006, BIG/Lincoln received construction bids from multiple general contractors. Bosphorus Construction ("Bosphorus") had the low bid and was hungry for the job. Based in Istanbul, Bosphorus had been active in Moscow for over 15 years and was also a large owner of office buildings and shopping centers. Most of these projects were joint ventures with the City of Moscow (the "City"), offering the apparent comfort of a close relationship with the City.[6] In contrast to the scenario in many Western markets, the City was Moscow's largest landowner, a legacy of communist times when the government owned all property. Patterson believed that Bosphorus' relationship with the City would come in handy, as the construction process would require many permits. However, the fact that Bosphorus was building the project while also serving as a landlord in the Moscow office rental market—and therefore a competitor—was a clear conflict of interest that gnawed at Patterson.

The construction contract required Bosphorus to deliver the first of three buildings before the end of 2007. As the first building to be delivered was also the smallest building of the three (6 stories and 10,000 m^2), this timeline seemed reasonable. The other two buildings (each 15 stories high, and totaling 66,000 m^2) were to be completed by September 2008.[7] Delivery deadlines were critical because BIG/Lincoln intended to sign pre-leases that would include tenant-driven occupancy deadlines. A significant delay by Bosphorus would therefore require BIG/Lincoln to make penalty payments to the tenants.

Bosphorus was only obligated to deliver the buildings in "shell and core" condition. This included all the fire and life safety systems, fully finished lobbies, lifts, and all utility connections. As was customary in Moscow, White Square tenants would be required to complete their own tenant improvements ("TIs").[8] By April 2006, with a newly issued construction permit in hand, Bosphorus commenced the build of White Square as Patterson allowed himself a moment of celebration. Everything seemed to be going according to plan.

Early Leasing Efforts Pay Off

BIG/Lincoln had spent much of the pre-construction period in 2004 and 2005 courting international companies active in Moscow to sign pre-leases. Its hunch about the appeal of a Class A project in a central Moscow location was borne out as both PwC and Deloitte wanted large leases.[9] As word of strong tenant demand spread, other premier tenants, including McKinsey & Co., were interested in the remaining space. Smaller tenants were attractive to Patterson because non-anchor tenants paid more in rent—in some cases up to 30 percent more. In mid-2006, lease negotiations were nearly finalized with Deloitte for 30,000 m^2, the largest pre-lease in Moscow history.

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[6] The City of Moscow often entered into ventures with developers, making it powerful in the local commercial real estate market.

[7] The project's 76,000 m^2 included 70,000 m^2 of office space and 6,000 m^2 of retail space.

[8] This contrasts with developed markets, where TIs are typically the responsibility of the landlord.

[9] The "Big Four" accounting firms (Deloitte, PwC, EY, and KPMG) were the four largest professional services networks in the world, offering audit, taxation, management consulting, actuarial, and corporate finance services.

But Deloitte balked at the idea of constructing (and paying for) TIs. The American company was conditioned to an experienced developer handling the TIs—and this proved to be both a problem and an opportunity for BIG/Lincoln. Vacancy in the Class A segment had fallen further to an unfathomable 0.5 percent and rents now exceeded \$700 per m^2. Earlier in the negotiation, BIG/Lincoln and Deloitte agreed to a rent rate of \$580 per m^2—by 2006, this turned out to be almost 20 percent below the going market rate.

BIG/Lincoln decided that if the development team agreed to both pay for and construct Deloitte's TIs, it could push for a rent increase. It seemed a crafty way to move the rent up to market rates. BIG/Lincoln proposed financing \$40 million of Deloitte's TIs (90 percent of the \$44 million in estimated TI costs) in exchange for increasing the rent to \$850 per m^2 and a 10-year lease (versus the original 7 years) (see **Exhibit 6**). Deloitte countered by asking for signage rights, nine months of free rent, and the right to terminate for construction delays.[10] BIG/Lincoln agreed to the counter terms, even though the termination right left it exposed to significant risk if the building was not ready on schedule. To protect itself, BIG/Lincoln set the lease occupancy date for June 2009—nine months after the scheduled construction delivery date of September 2008.

By trading nine months of free rent for a higher "face" rent, Patterson created additional potential value.[11] This also set a new market rent as a baseline for negotiating with other tenants. All in all, Patterson believed BIG/Lincoln was being well compensated for handling the TIs. Increasing the rent by \$270/m^2 contributed \$8.1 million of additional NOI. It represented a marginal yield of over 20 percent on \$40 million in TIs and a healthy development margin in excess of 50 percent.

Twin Leases

By late spring 2006, BIG/Lincoln's discussions with PwC to lease the other large building (32,000 m^2 of space) had reached an advanced stage. But with a hitch. PwC's existing landlord was a JV between Bosphorus and the City. The lease for that space was set to expire before White Square's scheduled completion date, necessitating a short-term extension to bridge the timing gap. With conflicting interests on all sides, BIG/Lincoln, PwC, and Bosphorus compromised. PwC's existing lease was extended to seven months after White Square's scheduled completion.

PwC also wanted Deloitte's TI deal. BIG/Lincoln agreed to fund \$45 million of PwC's TIs (90 percent of PwC's estimated TI cost of \$50 million). The rent initially quoted to PwC (\$550 per m^2) was even lower than the rent to which Deloitte had initially agreed (\$580 per m^2). PwC's rent was raised to \$850 per m^2, matching Deloitte's rent.

The Fix is In…

By 2006, over 80 percent of White Square was pre-leased to PwC and Deloitte at rents of \$850 per m^2, and pro forma NOI had increased to \$71 million (~70 percent higher than the initial 2004 pro forma of \$42 million). Including the \$85 million in TIs for Deloitte and PwC, the all-in development costs had also increased (to \$315 million) but the unleveraged development yield on cost had increased to 22.6 percent—versus the original pro forma of 18.3 percent.

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[10] Signage rights at a development of White Square's prominence had real economic value as a way to market to tenants.

[11] When NOI increased, project value would go up by a multiple—the reciprocal of the cap rate.

With high-quality tenants and a growing number of investors searching for acquisitions in the supply-constrained Moscow market, BIG/Lincoln now believed it could achieve a cap rate closer to 9 percent at sale. This would imply a value of $790 million on development costs of $315 million—a profit of $475 million, nearly four times the initial pro forma profit of $121 million.

The new pro forma looked great in BIG/Lincoln's financial model. But behind the numbers, BIG/Lincoln had meaningfully dialed up its construction risk. BIG/Lincoln had added $85 million in cost, nearly double the $100 million original hard cost budget, and significantly increased construction management complexity by taking on the TI construction. Both PwC and Deloitte were large, international firms with dozens of partners in Moscow. Such partnerships often have heated debates about office space design, resulting in frequent change requests that add to the construction timeline and increase the risk of a delayed completion.

	Revised Pro Forma with Pre-leases (as of June 2006)		
	Net Rentable Area (sq. m)	**$ / m2 / Year**	**NOI / Year**
Office	70,000	$ 850	$ 59,500,000
Retail	6,000	$ 1,500	$ 9,000,000
Total (exc. Parking)	**76,000**	**$ 901**	**$ 68,500,000**
Parking spaces	820	$ 3,200	$ 2,624,000
Total (inc. Parking)		**$ 936**	**$ 71,124,000**

	Rent	**Cap Rate / Development Yield**	**Value**
Exit Value	$ 71,124,000	9.0%	$ 790,266,667
Development Cost	$ 71,124,000	22.6%	$ 315,000,000
Profit			**$ 475,266,667**

Source: Compiled by the authors.

In parallel with the permitting and leasing efforts, BIG/Lincoln had been seeking construction financing. Hypoveireinsbank ("Hypobank") was a German bank that had been successful in Central Europe for years in the difficult emerging markets. The bank had made multiple loans to BIG/Lincoln in Central Europe and was anxious to access the Russian market through a borrower with whom they had experience in other markets. White Square checked all the boxes. By summer 2006, BIG/Lincoln and Hypobank had agreed to a $215 million loan, 70 percent of the $315 million in project costs—reflecting the value of the pre-leases (and reducing the bank's risk).

TROUBLE ON THE BOSPHORUS

As Russian author Leo Tolstoy once wrote, "It was smooth on paper, but we forgot about the ravines." In fact, this development was nowhere near as smooth as it appeared on paper. By January 2007, only nine months after construction started, Bosphorus was already six months behind schedule. The contractor had recently taken on several large projects without having enough labor or equipment to handle them all simultaneously. Rumors spread that Bosphorus was moving labor and equipment between the job sites frequently to mask its resource limitations.

During 2007 and 2008, there were ominous signs of trouble throughout the world economy, and the U.S. dollar was weakening precipitously against both the Euro and the Ruble. Currency volatility could be particularly problematic in emerging markets because many of the materials could not be sourced in the market where the project was being built. Bosphorus was buying materials from various countries in an array of currencies. Although the contract obligated Bosphorus to hedge the currency risk, it had not done so—a violation of the agreement. Patterson was reminded that delegating risk management was effective only when the counter-party was capable of managing the risk itself. Because the proverbial buck stops with the developer, mistakes by vendors and service providers often became a developer's biggest problem. BIG/Lincoln also began to sense that local materials procurement was a problem. The primary materials required for the initial 19 months of construction were concrete and steel; when Patterson requested copies of the procurement agreements, Bosphorus refused to provide them.

How Much?!?!

As Patterson's blood pressure rose, Bosphorus requested an urgent meeting. The Bosphorus project manager had a poker player's countenance as he walked into BIG/Lincoln's conference room. He explained that the monopoly concrete supplier in Moscow claimed the price had doubled. The supplier demanded that Bosphorus pay the elevated price, or no concrete.[12] As Patterson listened, he wondered to himself "how much could it possibly cost?" The answer: $40 million! His mind raced. Although the contract explicitly assigned this risk to Bosphorus, it pled financial distress and explained that BIG/Lincoln must pay the incremental cost. Patterson also knew the unfortunate maxim when working with contractors—if job losses exceed the outstanding guarantee ($20 million), the contractor could just "walk the site."[13]

Zeig Mir das Geld! ("Show Me the Money")

As if on cue, Hypobank called. Its board was increasingly wary of the bank's exposure in Russia. Many of its loans were in default in other European markets. After being bailed out by the German government, the bank was facing political pressure to exit the emerging markets. Hypobank handed BIG/Lincoln an ultimatum: If construction of White Square was not completed by June 2009—as mandated in the loan agreement—the bank would accelerate the loan. Hypobank's attorneys also claimed that the June 2009 completion deadline included TIs.

The lynchpin risk that Patterson's plan had been carefully crafted to avoid was manifesting itself as BIG/Lincoln's construction delivery contingency now seemed inadequate. It was becoming increasingly clear that the glue that held the whole project together was meeting the construction deadlines in the leases and loan agreements.

Now What?

BIG/Lincoln formulated a plan to get the tenants moved in on time. It would require Bosphorus' cooperation in a time of rapidly deteriorating goodwill between the two firms. BIG/Lincoln wanted to hire a second contractor to save time by parallel processing PwC and Deloitte's TIs on site while Bosphorus was finishing building construction.[14] Bosphorus resisted—arguing it could finish the project on time and a separate TI contractor would just disrupt building construction.

BIG/Lincoln worried there was a more sinister problem at hand. The overall vacancy rate in Moscow had spiked from 0.5 percent to 6 percent, and cap rates were climbing for the precious

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[12] Given the high cost of transporting concrete, suppliers often develop strong geography-based spheres of influence, where it is cost-prohibitive for buyers to procure concrete from alternate sources.

[13] In the construction contract, Bosphorus guaranteed a payment of up to $20 million to BIG/Lincoln if performance terms were not met. If Bosphorus expected its losses to exceed this liability amount, it might decide to walk away and force BIG/Lincoln to sue for payment of the guaranty, leaving Patterson <u>with</u> a lawsuit **and** <u>without</u> a contractor.

[14] Building contractors prefer to finish construction before allowing a TI contractor on site. Contractors prefer to work alone to minimize congestion on site and to reduce 'finger pointing' and competing liability claims.

few building sales in the market. Now that the Moscow office market was teetering on the edge, Bosphorus's motivations were conflicted. PwC was still paying \$500 per m^2 rent under a ~30,000 m^2 lease in a Bosphorus-owned building—\$15 million annually. The market had been buoyant when Bosphorus initially signed the contract, and Bosphorus was confident it could re-lease the space vacated by PwC. Patterson was concerned Bosphorus might not complete the buildings on time even if BIG/Lincoln agreed to the \$40 million price increase.

BIG/Lincoln was also working on a back-up plan to replace Bosphorus altogether. However, any new contractor would demand an increased price to reflect the current market conditions. In theory, half the price increase could be offset by collecting the \$20 million guarantee from Bosphorus for its contract default. But collecting the \$20 million claim was far from assured.

There was another consideration: no new contractor would provide warranties for the work that Bosphorus had already completed.[15] By terminating Bosphorus, BIG/Lincoln would waive the right to make future warranty claims, leaving BIG/Lincoln without remedy for any defects arising from Bosphorus' work. The absence of warranties could significantly affect the cap rate at sale and therefore reduce the exit price. There was no clear solution. But a decision had to be made quickly, as each day ate into the construction cushion.

The Duel with Deloitte

Adding to BIG/Lincoln's growing list of challenges, rumors were circulating about Deloitte's business. Although Deloitte originally only needed half of the 30,000 m^2 space, it had pre-leased the entire building. Deloitte planned to sublease the extra space initially, and expand over time. But with the declining economic conditions, Deloitte's growth plans proved overly aggressive as sublease prospects dimmed.

In mid-2008, as Patterson was focused on Bosphorus' construction problems and the economic environment spiraled downward, Deloitte asked for its own meeting with BIG/Lincoln. Deloitte announced it would not honor its pre-lease obligations. A peculiarity of Russian law stated that a "lease" could be signed only once the developer received a state-registered ownership certificate—after the buildings were completed. Posturing, Deloitte argued that the pre-lease might not be binding. Patterson's local lawyers assured him that Deloitte's threat was hollow and Russian courts would side with White Square. However, suing an anchor tenant was not an appealing option. It would take time and cost money. It would also lead to a loan default.

Deloitte demanded that BIG/Lincoln reduce its lease space by half. Although there was never a good time for a request like this, with ballooning vacancy rates throughout Moscow and amid a perilous problem with its contractor—this qualified as a terrible time. If BIG/Lincoln did not agree to a smaller lease, Deloitte might never pay any rent. Deloitte might also just declare local bankruptcy. BIG/Lincoln believed this was unlikely as Deloitte's global brand would be damaged. But these were challenging times and reputable companies were taking extreme actions merely to survive.

[15] Contractors provide performance warranties as an insurance policy against the inevitable problems that arise following construction completion. If a defect arises after construction is complete, and the contractor is deemed to be at fault, the developer can claim damages under the warranties set forth in the construction contract. Typically, contractors guarantee mechanical, electrical, and plumbing work for three years, structure for 10 years, etc.

KremlinCo's White Knight

Although KremlinCo was a well-capitalized metals and mining company pre-crisis, it too was suddenly in peril. In the face of falling commodity prices, the company's asset-backed lenders had declared a technical loan default, citing breaches of loan-to-value covenants. Desperate for cash, KremlinCo demanded that BIG/Lincoln agree to immediately sell the project. The joint venture agreement ("JV") between BIG/Lincoln and KremlinCo provided that neither partner could require a sale until one year after construction completion—a common JV provision. These were certainly not normal times, and agreements were being regularly re-visited. BIG/Lincoln had used offshore jurisdictions and the JV was governed under English law. But the business was on Russian soil, where KremlinCo had leverage. Given the conventional wisdom regarding the dangers of doing business as an outsider in Russia, Patterson did not want to "disappoint" KremlinCo. As long days bled into long nights, Patterson would dream up the darkest misfortunes that could befall him if he fell out of favor with his partner.

In its desperation, KremlinCo had found a Kazakh investor to buy White Square. Although KremlinCo had been transparent with the buyer about the raft of problems at White Square, the Kazakh investor was captivated, reasoning that it could get a trophy asset at a bargain basement price. KremlinCo assured BIG/Lincoln the Kazakhs could close the purchase before construction completion, thus providing KremlinCo the liquidity it needed and BIG Life the cash it wanted.

DECISION TIME

Patterson looked up from his paper-strewn desk and to the television across his office to see the latest news banner running across the bottom of the screen: Banks had lost more than $1 trillion since the onset of the subprime mortgage crisis in 2007. Meanwhile, the White House and U.S. Congress were negotiating a complicated ~$800 billion stimulus package. The bottom was falling out of the U.S. real estate market, and seasoned professionals didn't know what cap rates to assume—or even if tenants would pay the next month's rent.

Any decisions Patterson made in his own three-dimensional chess game would impact all parties in complex and unpredictable ways. Although the profit would be modest, the easy way out was the sale to the Kazakhs. But Patterson had worked tirelessly for six years to assemble the project of a lifetime. As he studied the pro formas, the range of outcomes was wide (see **Exhibit 7**). Rent and cap rate assumptions could hold, or, if things continued to deteriorate, could fall to the levels of his initial 2004 pro forma—or worse. His gut and guile told him that if he could overcome the challenges, White Square would still make an enormous profit. If he failed, he was sure to lose the project—and the $100 million his partners had entrusted to him—to the bank.

Patterson had one long day and one sleepless night until his all-hands meeting with KremlinCo, BIG Life, and Lincoln in 24 hours. His partners were expecting him to come prepared with a way forward. Regardless of his recommendation, he would have to anchor the discussion around a realistic pro forma to show how the basic economics would look should the deal succeed. Under these market conditions, that was no easy task. But he would need that analysis in hand to make a thoughtful recommendation to his partners between doubling down or cashing out.

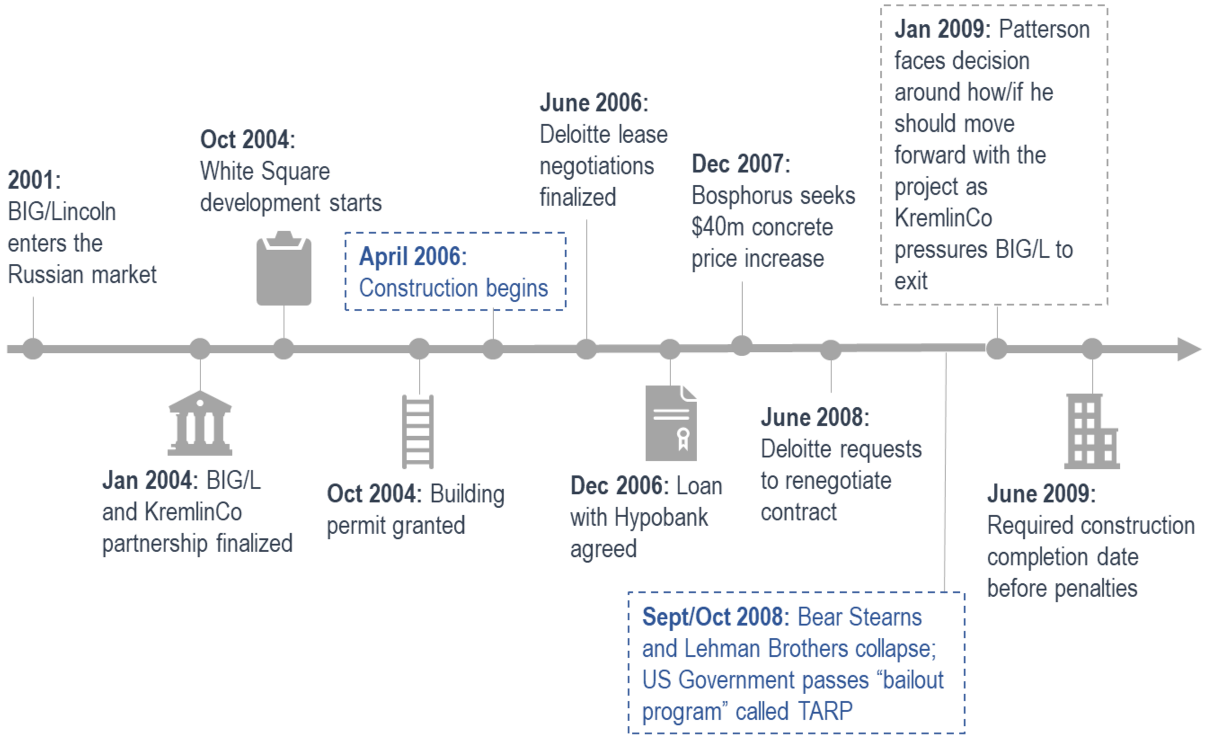
The analysis would need to be firmly grounded in the context of the deal dynamics and respective partnership interests (see **Exhibit 8**). The questions his partners would ask ran through his head like the ominous news banners streaming across his office television. Should he agree to Bosphorus's $40 million price increase? If so, would the conflict arising from Bosphorus' role as PwC's landlord allow it to complete construction on time? Could Deloitte's downsizing request be accommodated without undermining the income for the project? Could the construction deadline be met to avoid defaults under the loan agreement and anchor leases? Was Hypobank's threat real—and what could Patterson do to mitigate it? How was he to equilibrate the divergent interests of his partners, both in terms of their respective investment capital at risk and how much they stood to gain? Did KremlinCo, BIG Life, and Patterson / Lincoln all need to walk out of the meeting with the same path forward?

And the big one: Was he kidding himself? Should he just take the money and run? The clock was ticking. It was decision time, and fast.

Exhibit 1
Photographic Renderings of White Square

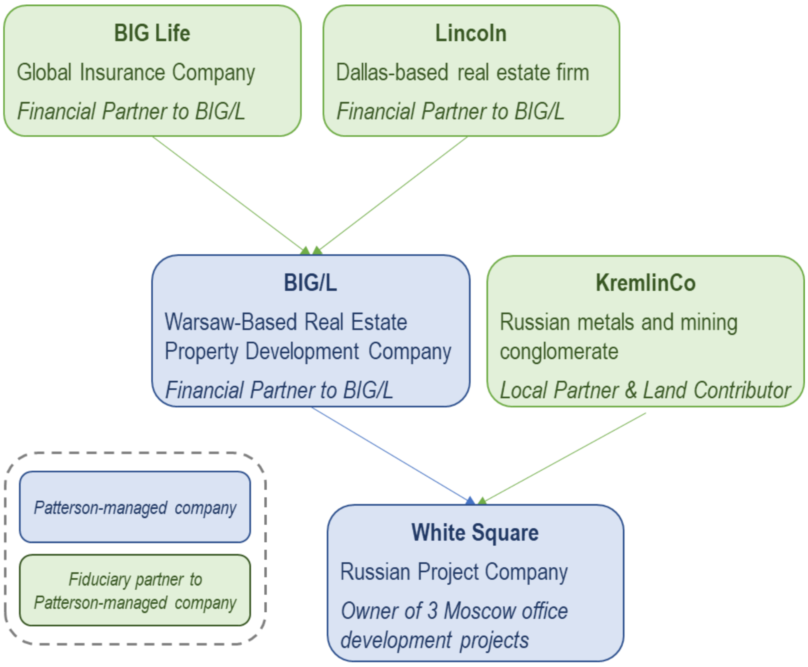
Source: Photographs provided by the authors.

Exhibit 2
White Square Development Timeline



Source: Compiled by the authors.

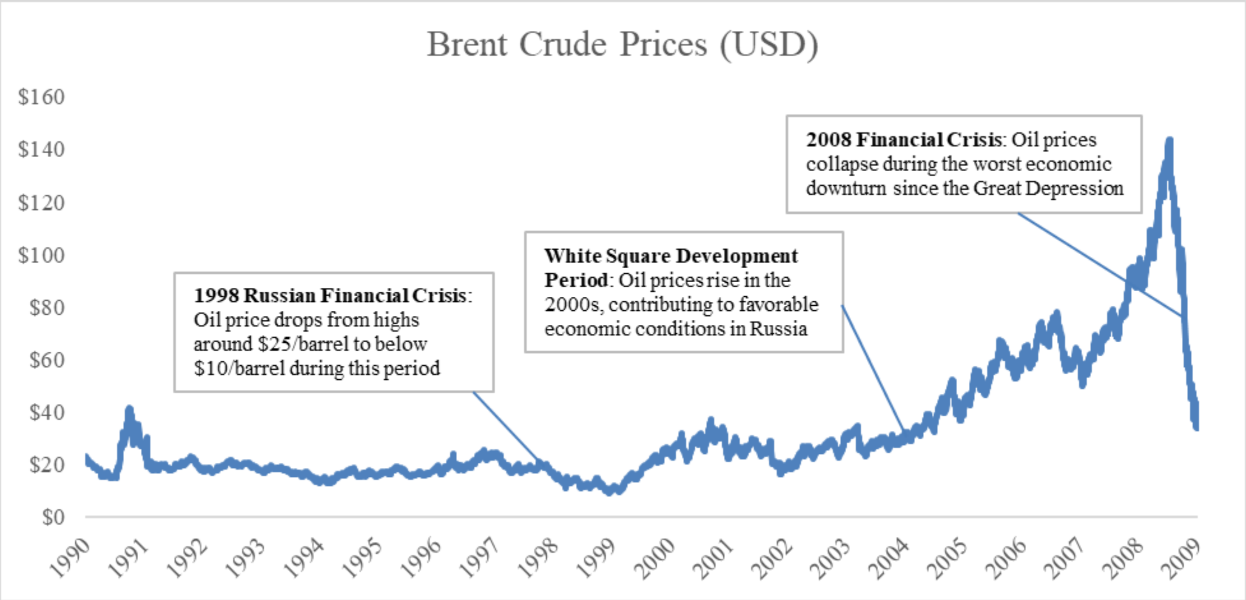
Exhibit 3
White Square Ownership Structure



Partnership agreements typically stipulate that professional investment managers agree to act with fiduciary responsibility when managing third-party investors' funds. The manager is required to act in the interests of the investors.

Source: Compiled by the authors.

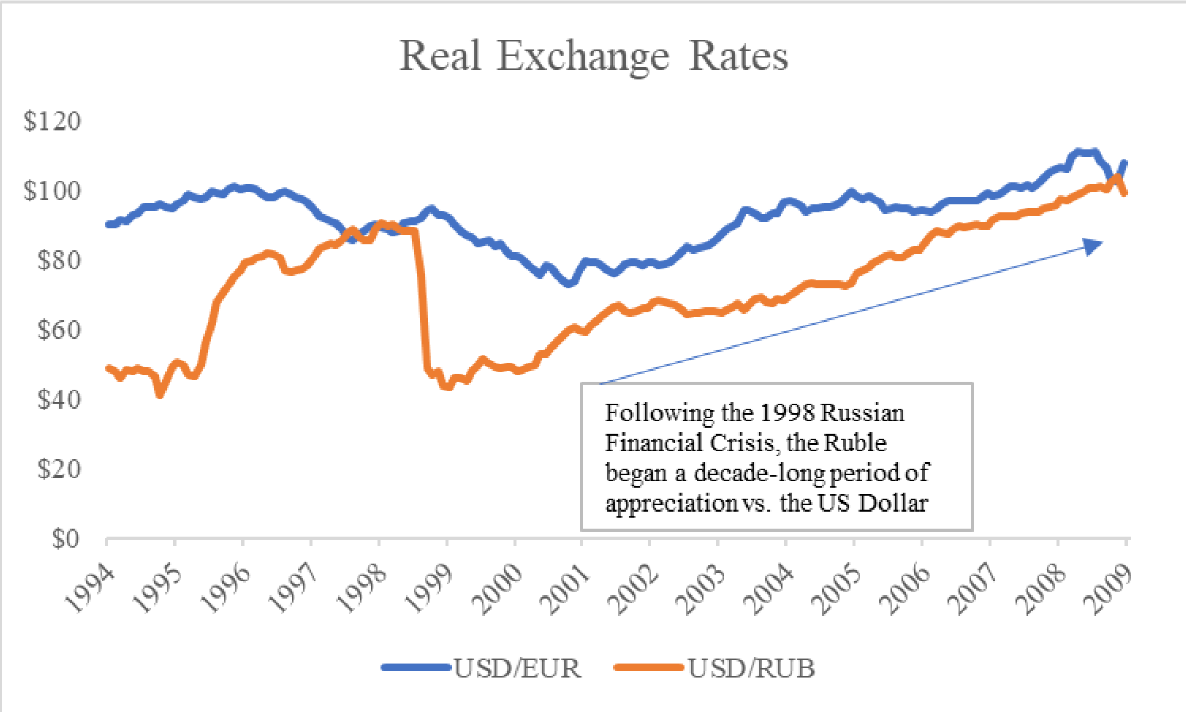
Exhibit 4
Oil Price Index (Brent Crude $/Barrel)



The Russian economy was sensitive to oil prices, and its government revenues even more so. In 1997, many developing East Asian economies experienced currency crises that destabilized much of the region. This precipitated a 50+ percent fall in global oil prices, which was exacerbated by a decrease in demand. The accompanying decline in Russia's foreign exchange reserves led to Russia's default on its domestic debt on August 17, 1998. Many Western investors lost money when Russia's bond markets shut down. Most notably, the fund Long-Term Capital Management lost $4.6 billion during the worst months of the crisis.

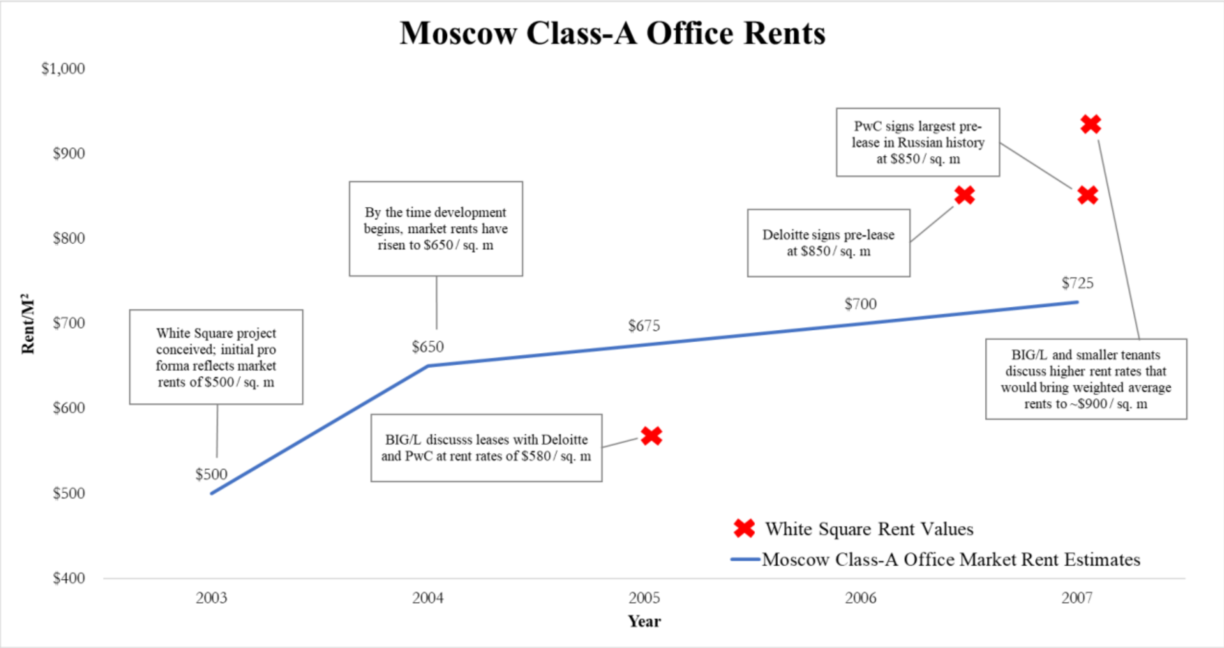
Source: Compiled by the authors based on data provided by Global Financial Data.

Exhibit 5
Foreign Exchange Rates



Source: Compiled by the authors based on data provided by Global Financial Data.

Exhibit 6
Moscow Office Space Rent Progression



Source: Compiled by the authors.

Exhibit 7
Pro Forma Progression

A Patterson began developing White Square in 2004 to an 18.3% yield on $230 million of cost, with his assumptions for both cap rates and rent in line with the prevailing values in the market at the time. B By 2006, with the Russian macro economy improving and the development attracting premier tenants, Patterson was able to move the cap rate to 10%, implying an additional $71 million of project value. C At the same time, prevailing rents in the market had increased to $650/sq m for comparable properties, implying $5.5 million more annual NOI. At a 10% cap rate, this increased the project value by $55 million. D By agreeing to complete the TIs, Patterson increased the contracted rent by over $23 million annually, a nearly 50% increase. However, project costs went up by $85 million and the risk of completing construction on time was increased as well. In all, Patterson was rewarded with an implied $150 million of additional value for assuming responsibility for the TIs. E To reflect the supply-constrained market and the signed contracts with two multi-national anchor tenants, the assumed cap rate for White Square was improved to 9%. This generated an incremental $79 million in paper profits. F As the market began to deteriorate, Bosphorus demanded a $40 million price increase. G With world financial markets in freefall, wavering tenants, and in the face of potentially catastrophic construction delays, Patterson was left wondering what assumptions were

	Initial '04 Pro Forma	Improving Market Conditions: '06-'08				Worsening Market Conditions: '08-'09	
	A	*B*	*C*	*D*	*E*	*F*	*G*
	@ 12% Cap Rate	**Cap Rate Change from 12% to 10%**	**Rent Increase to $650/sq m**	**Rent Increase to $850/sq m plus TIs**	**Cap Rate Change from 10% to 9%**	**Concrete Price Increase**	**Cap Rate Compression & Rental Degredation**
NOI	$ 42,068,000	$ 42,068,000	$ 47,668,000	$ 71,124,000	$ 71,124,000	$ 71,124,000	?
Cap Rate	*12.0%*	*10.0%*	*10.0%*	*10.0%*	*9.0%*	*9.0%*	*?*
Project Value	**$ 350,566,667**	**$ 420,680,000**	**$ 476,680,000**	**$ 711,240,000**	**$ 790,266,667**	**$ 790,266,667**	**?**
Cost	230,000,000	230,000,000	230,000,000	315,000,000	315,000,000	355,000,000	**355,000,000**
Profit	**$ 120,566,667**	**$ 190,680,000**	**$ 246,680,000**	**$ 396,240,000**	**$ 475,266,667**	**$ 435,266,667**	**?**
Yield on Cost	*18.3%*	*18.3%*	*20.7%*	*22.6%*	*22.6%*	*20.0%*	*?*
Development Margin	*52.4%*	*82.9%*	*107.3%*	*125.8%*	*150.9%*	*122.6%*	*?*

Source: Compiled by the authors.

Exhibit 8
Proceeds Under Various Scenarios

In a development deal like White Square, there are tranches of returns under a sale scenario. 1 First, the initial capital that is invested will be returned pro rata to the investors according to the amounts each invested. 2 Second, each investor will receive a preferred return (or just 'preferred') that is also calculated based on the pro rata amounts invested. In this instance, the preferred is calculated to be 8% per annum, compounded annually for 3 years. 3 Finally, the remaining "participating" profits are divided according to a formula that allows the developer to participate disproportionately in the upside to incentivize high return performance. In the case of White Square, Patterson / Lincoln received 20% of the participating profits, and the other 80% of the profit pool was to be split pro rata according to each party's investment amount.

Return of Capital Plus Preferred	**Pro Rata Share of Capital Invested**	**1 Return of Capital Invested**	**2 Preferred Return**	**Total Amount to Return Capital and Preferred**
KremlinCo Share	*33.0%*	33,000,000	8,570,496	41,570,496
BIG Life Share	*62.0%*	62,000,000	16,102,144	78,102,144
Patterson / Lincoln Share	*5.0%*	5,000,000	1,298,560	6,298,560
Total	***100.0%***	**100,000,000**	**25,971,200**	**125,971,200**

3 Participating Profits	**Sale Case**	**Peak Pro Forma**
Sale Proceeds (Net of Debt)	125,000,000	435,266,667
Total Amount to Return Capital and Preferred	125,971,200	125,971,200
Profits after Return of Capital and Preferred (the "Carry Pool")	**(971,200)**	**309,295,467**

Share of Participating Profits			
KremlinCo Share	*26.4%*	-	81,654,003
BIG Life Share	*49.6%*	-	153,410,552
Patterson / Lincoln Return of Capital Share	*4.0%*	-	12,371,819
Patterson / Lincoln Promote Participation Share	*20.0%*	-	61,859,093
Total	***100.0%***	**-**	**309,295,467**

Total Proceeds by Party

KremlinCo Share	**Sale Case**	**Peak Pro Forma**
Return of Capital	33,000,000	33,000,000
Preferred Return	8,570,496	8,570,496
Participating Profit	-	81,654,003
Total	**41,570,496**	**123,224,499**
Difference in Profits between Peak Pro Forma and Sale Case	*n.a.*	*81,654,003*
Maximum Potential Loss	-	*(33,000,000)*
Total Proceeds / Capital Invested	*1.3x*	*3.7x*

BIG Life Share	**Sale Case**	**Peak Pro Forma**
Return of Capital	62,000,000	62,000,000
Preferred Return	16,102,144	16,102,144
Participating Profit	-	153,410,552
Total	**78,102,144**	**231,512,696**
Difference in Profits between Peak Pro Forma and Sale Case	*n.a.*	*153,410,552*
Maximum Potential Loss	-	*(62,000,000)*
Total Proceeds / Capital Invested	*1.3x*	*3.7x*

Patterson / Lincoln Share	**Sale Case**	**Peak Pro Forma**
Return of Capital	5,000,000	5,000,000
Preferred Return	1,298,560	1,298,560
Patterson / Lincoln Return of Capital Share	-	12,371,819
Patterson / Lincoln Promote Participation Share	-	61,859,093
Total	**6,298,560**	**80,529,472**
Difference in Profits between Peak Pro Forma and Sale Case	*n.a.*	*74,230,912*
Maximum Potential Loss	-	*(5,000,000)*
Total Proceeds / Capital Invested	*1.3x*	*16.1x*

Source: Compiled by the authors.