# Financing mechanisms

QUESTION: An overview of the funding mechanisms available to the REIT for the development.

* Reasons for use of financing besides issuance of equity – need to answer why REITS may finance part of their project with debt
* The trade-off theory states that an optimal capital structure exists where the value of tax deductibility of interest payments is offset by the cost of financial distress.
* Tax exemptions as an incentive for debt
* One reason to issue debt despite no apparent benefits is to avoid the adverse selection cost of equity, as pecking order suggests
* Debt is a very important issue in the world of real estate investment. The main reason for
* this was discussed in chapter 1 (section 1.9). Real estate is a large, lumpy asset class, and on
* average, it costs a lot to buy. In order to do so, an individual may have to borrow money, and
* even a global institution may find it hard to fully diversify its portfolio (see chapter 5 ), so using
* debt is a way of stretching its equity capital across more assets.

**Joint ventures**

* **Look at REIT joint ventures in Australia**

Real estate investment trusts (REITs) dispose of properties in their portfolio either completely or partially. Dispositional joint ventures (DJVs) represent an organisational arrangement in which a REIT sells a portion of its real estate portfolio, either an individual property or a number of properties, to a ﬁnancier, usually a pension fund or other institutional investor. The REIT retains a minority interest in this equity joint venture and receives the proceeds from the sales transaction, usually cash. It also frequently retains management rights to the joint venture properties. The joint venture partner contributes cash and in return receives a majority interest in the joint venture as well as an experienced property manager with an equity stake. Some REITs maintain the option to buy back the partial interest of their joint venture partner and/or sell their interest to the partner at a later point in time.

* JVs are described as “hybrid” structures as their governance shares characteristics of the hierarchical control within a firm and the lack of definitive control in market transactions (Williamson, 1979). Similar to independent firms, JVs are governed by a board of directors, and the partners receive control and cash flow rights proportional to their equity investments
* REITs form dispositional JVs with ﬁnanciers, often ﬁnancial institutions. In the typical dispositional JV, the ﬁnancial partner contributes cash to the JV in exchange for JV shares. The REIT contributes previously-owned property to the JV, usually receiving some JV shares in return, but always receiving a substantial amount of cash.
* Normally, the REIT will continue to manage the property, and will receive a fee from the JV for doing so. Usually, there is an exit provision that allows the REIT to dissolve the venture and recover full ownership of the property at some future time, even though the REIT generally is a minority shareholder of the JV.
* The advantages of the JV form for the REIT are as follows: 1) Mandatory payments are reduced or, if the JV is ﬁnanced entirely with equity, eliminated, thus reducing the probability of future default. 2) The REIT keeps debt off of its balance sheet. Even if the project is mortgaged, the REIT need not consolidate this debt in its balance sheet, since the REIT’s interest is a minority interest. 3) The REIT has more options regarding its future strategy, and more ﬂexibility as to the timing of these options. 4) Management fees smooth the REIT’s income, giving the REIT a priority claim on some portion of the venture’s cash ﬂows.

**Mezzanine Financing**

* In commercial real estate, traditional bank financing is typically utilized as the primary source of capital. The bank holds the first mortgage position, and as such, this loan falls at the bottom of the capital stack. Most borrowers will seek upwards of a 75% loan-to-value ratio for their deals, though not all are able to secure this level of leverage for one reason or another. This is where mezzanine debt comes into play.

* Mezzanine debt is a bank or private money loan that is subordinate to senior debt financing. It holds the second position in the capital stack, after all other recorded debt but ahead of all equity positions. The rates for mezzanine debt can often be two or three times as high as traditional bank debt, in most cases no principal amortization is required, and mezzanine debt takes no part in back-end profit sharing; it is strictly a risk mitigated yield play for investors.
* Although traditionally investors stepped into real estate as either senior lenders or equity providers, mezzanine financing has been on the table for a few decades now as a tool for developers to execute their business plan.
* Traditional mezzanine in a value-added transaction. This is the most common form of mezzanine financing
* Loans for acquisition of stabilized returns. These loans are made by conduit lenders generally up to 90% of the capital structure with debt service coverage of at least 1.1 to 1.0. These loans generally cost 4% to 7% over the London Inter-Bank Offer Rate (LIBOR), or fixed 10–12% plus points.
* Interim loans that are made by lenders who are making first mortgage loans up to 90% of the capital structure. These loans (1) require returns that blend the senior component and the mezzanine component, (2) generally have existing debt coverage of at least 1.1 to 1, and (3) are less than 90% of the capital structure. Typically such loans require a 1% origination fee, a 1% to 2% exit fee, and 200 to 325 over LIBOR depending on the perceived risk and the type of investment. Apartments and retail get the lowest spreads, whereas suburban offices and hotels require the highest spreads.
* Traditional mezzanine loans for value-added projects. If the loan is up to 90% of the capital requirements, the loan requires interest rates in the 11% to 16% range.
* In exchange for undertaking the risk that senior lenders were unwilling to accept, mezzanine lenders expect higher returns and other monetary incentives.
* Mezzanine financing is unsecured (i.e. no lien on asset collateral), so the chance of receiving full recovery proceeds in debt restructuring or liquidation is unlikely.
* 20 LLC has entered into a mezzanine loan agreement with Torchlight as partial payment of its prior Senior Loan. The Mezzanine Loan has an original principal amount of $30,000, and bears interest at 15% per annum, of which 7% percent is paid currently during the first four years of the term and 10% is paid for the remainder of the term, and is due on October 17, 2023. Unpaid interest accrues and is added to the outstanding principal amount of the loan. The Mezzanine Loan requires borrower to pay a prepayment premium equal to the difference between (1) the sum of 150% of the principal being repaid (excluding the accrued interest) and (2) the sum of the actual principal amount being repaid and current and accrued interest paid through the date of repayment. This repayment feature operates as a prepayment feature since the difference between (1) and (2) will be zero at maturity.

**Crowdfunding**

**Public debt offerings:**

* <https://www.reit.com/news/blog/market-commentary/climbing-treasury-yields-pressured-reits-and-broad-markets-august> similar yields to treasury bonds

**Private debt:**

* Many of the lenders described above are not comfortable granting mortgages over ofﬁce, retail, industrial or other non-residential properties or have decided that such mortgages are outside their mandate.
* Because there is little published data about sources or terms of non-residential

mortgages, the search for a loan can be time-consuming unless it is limited to the

previous contacts of the investor. These are reasons for using mortgage brokers to

ﬁnd commercial property loans (Roth and Lang 2005, p 116).

* Several matters should be considered by the parties when initially structuring the credit facility. First, depending on the borrower's credit quality and financing needs, the facility will be structured either as secured (with collateral) or unsecured (no collateral). In either case, the REIT would be expected to identify a pool of assets that would support the fnancing, and the amount available to be borrowed would be based on a percentage of the value of the properties in the asset pool, all as determined by the lender through its underwriting process
* Other structuring issues that should be considered at an early stage are, in the case of a revolving credit facility, whether it will include sub-facilities for swing line borrowings (short term, same-day advances) and/or letters of credit and whether accommodation should be made for a possible future upsizing of the facility. If additional lending may be necessary (e.g., in the case of a near-term or pending assets acquisition), the parties should consider whether to include a delayed draw term loan. Such a term loan is advantageous to the borrower because the lenders are fully committed to fund. One possible disadvantage, however, is that after an initial grace period the borrower will be obligated to pay a “ticking fee” (an unused commitment fee) until the time the delayed draw term loan facility is drawn (or terminated).
* Debt finance may also be unsecured (meaning that the bank has no access to any specific assets in the event of default), a facility usually only made available to high-quality REITs (see chapter 9 ) and other companies
* Need to link to why this is capped at around 60% usually

Fees:

* Typical fees include arranger fees, upfront fees and, for a revolving credit facility, unused commitment fees. An arranger fee is paid to the agent or lead lender(s) for the structuring and syndication of the facility and is typically paid in full at closing based on the entire amount of the facility. An upfront fee is paid to the administrative agent for the benefit of each lender based on its committed loan amount.
* [3.60] In Australia, borrowers can generally choose between an interest rate that
* may vary over time or one that is ﬁ xed for one to ﬁ ve years. A few lenders have
* offered loans with interest rates ﬁ xed for 10 years. Some lenders offer the ﬂ exibility
* for part of the loan to be on a variable rate and part on a ﬁ xed rate (one deﬁ nition
* of “split loans”; Waxman 2004, p 47). The choice between ﬁ xed and variable
* interest rates is considered in [4.140].
* Considerations into variable of fixed rate interest terms. Variable-rate financing may be cheaper initially, but interest rates can be increased with little warning, and these increases can be swift and very large.
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* Commitment fee to provide capital as it is required to be drawn, or unused commitment fees. If there is a delayed draw term loan, the financing may include a ticking fee which is particularly important to the lender if the parties understand that the borrower may ultimately access a less expensive source of capital and thus may not draw on the commitment (and pay associated fees or interest) at the time the acquisition closing date arrives

Loan length:

The following types of loans are available for different lengths.

* Term loans or permanent ﬁnance for residential investors can be for up to 30 years for amortising loans and 10 years for interest only loans. For commercial properties, these loans are typically between three to 10 years (although rarely more than three years in 2009);
* line of credit loans, such as home equity loans which are borrowings secured on residential property with a minimum of interest only payments, are typically for ﬁve or 10 years;
* construction ﬁnance, which is repaid upon the completion of a project and is usually for one to two years; and
* bridging ﬁnance is unsecured short term lending, say for three to six months, whilst permanent ﬁnance is secured.

Financial covenants:

* A key element of REIT credit facility documentation is the nancial covenants. These covenants are designed to measure the health of the entire company as well as the BBAs or UPAs because the lenders are looking both to the value of the underwritten assets and the credit of the REIT.

The most typical nancial covenants that

relate to underwritten assets are:

(i) leverage ratio tests, which measure

whether the value of a REIT's

assets is sucient to satisfy

debt,

(ii) interest or debt service coverage

ratios, which measure whether

net operating income is sucient

to cover interest payments, and

(iii) debt yield tests, which measure

whether net operating income is

sucient to cover debt pay-

ments (these have recently be-

come more common than debt

service coverage ratio tests, al-

though they serve the same

purpose).

E a leverage ratio, which compares the

debt of the REIT and its subsidiaries to

the value of all of the assets of the REIT

and its subsidiaries;

E a secured leverage ratio, which com-

pares the secured debt of the REIT and

its subsidiaries to the value of all assets

of the REIT and its subsidiaries;

E a xed charge coverage ratio, which

compares the EBITDA of the REIT and

its subsidiaries to the sum of interest

and scheduled principal amortization

E an interest coverage ratio, which com-

pares the EBITDA of the REIT and its

subsidiaries to the interest expense at-

tributable to all debt of the REIT and its

subsidiaries;

E a minimum tangible net worth test, which

is usually computed as 75% of tangible

net worth at closing plus 75% of the net

proceeds of any equity issuances con-

ducted after the closing date; and

E a dividend payout ratio test, which limits

the amount of distributions that may be

made by the REIT to its shareholders to

the amount necessary to maintain REIT

status and avoid imposition of income

and excise taxes under the U.S. Tax

Code.