# Financing mechanisms

Real estate transactions involve commercial properties that are heterogeneous, complex, and illiquid. Effective valuation of such assets require careful monitoring and specialized knowledge of unique financing arrangements and local market conditions. Borrowing money allows investors, whether individuals or institutions, to diversify their portfolios across more assets, thereby optimizing their use of equity capital. Literature suggests that the liability structures of REITs are bifurcated, with some REITs opting for secured debt and equity, while others choose more complex structures.

In this section, we will explore various financing mechanisms utilised by AREITs to achieve their capital structure objectives. These mechanisms include joint ventures, mezzanine financing, crowdfunding, and public and private debt offerings. By examining these mechanisms and the factors influencing capital structure, we can gain valuable insights into the financial strategies of AREITs and their impact on the real estate market.

**Joint ventures**

Dispositional joint ventures (DJVs) are described as hybrid structures and provide AREITS a strategic option for disposing of properties in their portfolio. In a DJV, the REIT sells a portion of its real estate assets to a financial partner, typically a financial institution, in exchange for joint venture shares and a substantial amount of cash. The REIT retains a minority interest in the joint venture and often retains management rights over the properties. Like independent firms, DJVs are governed by a board of directors, and partners receive control and cash flow rights proportional to their equity investments. This structure allows REITs to benefit from the advantages of joint ventures while maintaining some level of control and flexibility in their real estate investments.

The use of DJV’s as a funding mechanisms reduce probability of default by lowering mandatory payments, and allow the AREIT to keep debt off its balance sheet, enhancing its financial position.

DJVs also provide the AREIT with more flexibility in its future strategy and the timing of its options.

The AREIT receives management fees from the joint venture, smoothing its income and providing a priority claim on some of the venture's cash flows.

**Mezzanine Financing**

Mezzanine financing is a form of capital employed in commercial real estate deals, offering flexibility and assuming higher risks compared to traditional bank loans. Positioned between senior debt and equity in the capital structure, mezzanine debt is typically provided by banks or private lenders. It provides lenders with higher returns in exchange for accepting risks that senior lenders are unwilling to take. Luc Nijs, in his work "Mezzanine Financing: Tools, Applications, and Total Performance," illustrates this with an example. If a senior debt lender is willing to provide up to 75% of the financing for an acquisition or redevelopment project, a mezzanine loan would advance capital requirements between 75% to 90% of the acquisition or redevelopment costs, such that the owner-operator is required to pay 10% of the remaining cost.

Another application of mezzanine financing is through preferred equity arrangements. Here, the mezzanine lender becomes an investor in the borrower or owner, receiving a preferred return and a liquidation preference ahead of equity investors. Unlike traditional debt, preferred equity provides investors with ownership interests such as preferred stock, membership in an LLC, or partnership interests. In the event of a sale, refinance, or liquidation, preferred equity investors are paid back their principal investment before any distributions are made to equity holders, providing them with a higher level of security and priority in recouping their investment.

**Private (Senior) debt:**

In the capital structure of AREIT financing, senior debt plays a critical role by providing low-risk funding essential to many real estate transactions. Senior debt holders are granted priority over all other debt and equity holders, ensuring they are the first to be compensated in the event of a default. Consequently, senior debt often offers the lowest available interest rates.

The amount available for borrowing is determined by the lender's underwriting process, which considers the value of the properties in the asset pool and the borrower's credit quality and financing needs. To mitigate risk, senior debt exposure is typically limited to around 60% of the asset value at any given time. Some lenders may reduce the maximum LVR if they consider that the property type or its features might make it difﬁcult to resell, particularly in a market downturn. For income-producing commercial properties, lenders also assess the debt coverage ratio (DCR) or *interest cover*, ensuring that the net rental income exceeds the loan payments or interest.

Considerations and fees

When considering financing options, borrowers must weigh the advantages and disadvantages of variable versus fixed-rate interest terms. While variable-rate financing may offer lower initial costs, it also carries the risk of interest rate increases, which can occur suddenly and substantially. In Australia, borrowers typically have the option to choose between variable or fixed-rate interest terms, with fixed-rate options available for periods ranging from one to five years, and occasionally up to 10 years.

Alongside interest rates, borrowers should also consider the various fees associated with their financing arrangements. These fees may include upfront fees, unused commitment fees for revolving credit facilities, and arranger fees paid to the lead lender(s) for structuring and syndication. Additionally, some financing arrangements may include commitment fees that are paid as capital is drawn, or fees associated with delayed draw term loans, such as ticking fees. These fees are particularly relevant if there is a possibility that the borrower may secure more favourable financing terms in the future and choose not to draw on the committed capital, thus avoiding associated fees or interest payments.

Loan Length

Loan length varies depending on the type of loan. For residential investors, term loans can be up to 30 years for amortizing 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 recent years. Line of credit loans, such as home equity loans secured on residential property, typically have terms of five or 10 years. Construction finance is usually repaid upon project completion and is typically for one to two years. Bridging finance, which is unsecured short-term lending, is typically for three to six months, while permanent finance is secured.