BTR SERIES PART 5: DEBT FUNDS OPTIONS—NHFIC AND ALTERNATIVES

Date: 22 August 2023

Australia Finance and Real Estate Alert

By: Jennifer McCosker, Alan S. Maclean

Investment in build-to-rent (BTR) residential developments is being driven by community and government demand, tax and other government incentives, longer term returns and lower maintenance costs and incentives compared to office or commercial developments.

Funding for BTR residential developments takes many different forms and is generally provided by private sector investors or financiers, governments or government authorities or a combination of the two.

However, funding will only be provided by the private sector if the income streams from the development are secure and the post-tax returns meet market expectations. Equally, funding by governments or government authorities will usually be linked to set eligibility criteria, including environmental and sustainability standards, affordable rents and places, certainty of tenure and communal amenities and services.

We examine below various funding models and the different risks of funding or investing in the BTR sector.

DIRECT LENDING DEBT FINANCE

BTR developers are finding ways to secure debt funding as Australian lenders become more familiar with this asset class. Whilst historically the "Big Four" banks have not demonstrated a significant amount of interest in this sector, this is starting to shift as bankers familiarise themselves with the risks of this asset class.

Non-bank lenders provide an alternative to traditional bank financing as they generally offer more flexible terms to support the project. Return hurdles may be an issue, however given the cost of debt from non-bank lenders.

Typically, BTR facilities are structured as either bilateral or syndicated loan facility agreements. Some syndicated facility agreements take the form of loan note subscription facilities with the notes being offered so as to satisfy the “public offer test” under s. 128F of the Income Tax Assessment Act; and for any interest payments to non-resident noteholders to be exempt from interest withholding tax.

COMMUNITY HOUSING PROVIDERS AND NHFIC

National Housing Finance and Investment Corporation (NHFIC) is a corporate Commonwealth entity with the purpose of improving housing outcomes for Australia. In particular, NHFIC encourages investment in the social or affordable housing sector and provides loans, investments and grants that support Commonwealth, state or territory activities relating to housing. It has played a pivotal role in providing funding to developers to support the BTR initiative.

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NHFIC manages the AU$1 billion National Housing Infrastructure Facility which offers concessional loans, grants and equity funding to help support critical housing enabling infrastructure.

Through the Affordable Housing Bond Aggregator (AHBA), NHFIC also provides low cost, longer tenor loans to registered community housing providers to support the provision of more social and affordable housing. NHFIC funds AHBA loans by issuing social bonds into the wholesale capital market with the benefit of a Commonwealth guarantee.

In addition, NHFIC provides grants of up to AU$20,000 to all registered community housing providers.

As mentioned in Part 4 of this Series, the funding regimes implemented by the Australian government are similar to the models employed in the United States. In the United States, close to half of all multifamily mortgage debts in the United States are said to be backed by US federal government agencies such as the Federal National Mortgage Association, the Federal Home Loan Mortgage Corporation, and the Government National Mortgage Association (colloquially known as “Fannie Mae,” “Freddie Mac,” and “Ginnie Mae” respectively). These organisations are committed to sustainable financing for affordable housing.

DEVELOPER FUNDING MODEL

Another funding model is for developers to own, fund and develop the BTR project by way of joint venture, partnership or co-ownership arrangements. Funding is provided by way of equity or debt funding regulated by joint venture agreement, partnership agreement or co-ownership agreement as applicable. All critical contracts, such as finance, construction, operator and tenancy agreements for the project, are entered into by the developer entity.

INVESTOR FUNDING MODEL

Another funding model is for an investor or investors (through a fund or trust) to own the BTR project. Funding is provided by way of equity or debt funding sourced by the investor. All critical contracts, such as development, operator and tenancy agreements for the project, are entered into by the investor entity. Generally, the developer arranges construction of the project and enters into the construction contract.

MANAGED INVESTMENT TRUSTS

Where the investor entity under the investor funding model is a Managed Investment Trust (MIT), which has foreign investors we considered in Part 2 of this Series, the reduced withholding tax rate that will apply from 1 July 2024 and the potential traps which may apply in qualifying for such a reduction. We also raised the spectre of the new thin capitalisation rules, which are to apply from 1 July 2023 and may limit the availability of debt deductions for MITs and other investment property trusts.

KEY RISKS OF BTR FUNDING MODEL

There are several obstacles that developers are currently facing when trying to secure debt funding.

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BTR projects do not have long term lease commitments and utilise short lease terms which may not be extended or renewed. This poses difficulties in the lending credit approval and underwriting process—financiers require contractual certainty as to future payment streams.

Many lenders are hesitant to provide funding to developers without a proven track record of success in the BTR market as it is a relatively new asset class. Additionally, there is little historical data with respect to valuations for BTR projects which provides financiers with less certainty.

This has led to lenders adopting a more conservative approach to loan to value ratios and requiring developers to provide greater equity than for build to sell projects.

Lenders must assess the risks of BTR projects during four distinct phases:

1. Land acquisition and early works;
2. Construction;
3. Pre-leasing and launch; and
4. Operation and occupation.

Lenders regularly assess land acquisition and construction risks for build to sell projects and the same risk mitigants will apply, such as loan to value and loan to cost covenants, quantity surveyor reports, builder expertise and capability assessment, builder's side deeds, key development and management agreement tripartite deeds, cost overrun undertakings, builder bank guarantees and adequate insurance coverage.

If the lender is committing to provide funding beyond practical completion of the project, it may provide separate construction and operations tranches with specific conditions precedent, which must be satisfied to transition from the construction to the operations tranche. These conditions may include:

5. Evidence that practical completion of the project has occurred;
6. Pre-leasing commitments and total rental levels have been reached;
7. Acceptable as complete (with leasing commitments) valuation;
8. All body corporate amenities are fully operational;
9. Rental account and service account in the control of lender;
10. Approved leasing agent;
11. Initial compliance with new operations phase financial covenants (e.g. debt service or interest cover ratios, forecast and actual net income tests, loan to value ratio, weighted average lease expiry covenant or maintenance capex undertaking); and
12. Initial leasing report from the leasing agent.

Lenders will usually require amortisation of the loan during the operations phase and will set a repayment schedule based on forecast leasing and net rental income levels.

Depending on the level leasing pre-commitments achieved, lenders may require rental guarantees or other incentives from developers to attract leasing commitments.

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Exit strategies for lenders during the operations phase include any combination of the following:

13. Conversion of rental lots to sale lots;
14. Refinancing by another lender or fund;
15. Division of project into separable portions which can be separately refinanced, sold or leased;
16. Take out by equity investors; and
17. As a last resort, enforcement and sale as a going concern.

Lenders will pay particular attention to the developers, managers and operators of BTR projects as they recognise that strong development and operational management is required for BTR assets to be successful. Tripartite agreements which allow for cure and step in rights are a central part of the lender's security package.

Some other important considerations for lenders and investors may be FIRB, heightened government compliance standards and reporting requirements where green lending principles are involved, affordable housing incentives are being provided to the project or lots in the project are being leased to registered community housing providers.

MISSING PIECE OF PUZZLE

Ultimately, BTR projects may be the missing piece of not only the affordable housing puzzle but also the national housing shortage. Critical to this however is the ability of developers to obtain investor funding from domestic and offshore investors and for the debt funding market for this asset class to expand and mature.

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KEY CONTACTS



JENNIFER MCCOSKER
PARTNER

SYDNEY
+61.2.9513.2333
JENNIFER.MCCOSKER@KLGATES.COM



WILL GRINTER
PARTNER

MELBOURNE
+61.3.9640.4411
WILL.GRINTER@KLGATES.COM



SANDRA STEELE
PRACTICE AREA LEADER - REAL ESTATE

SYDNEY
+61.2.9513.2528
SANDRA.STEELE@KLGATES.COM



JAMES DURNALL
PARTNER

SYDNEY
+61.2.9513.2481
JAMES.DURNALL@KLGATES.COM



ALAN SCHACTER
PARTNER

NEW YORK
+1.212.536.3908
ALAN.SCHACTER@KLGATES.COM



ALAN S. MACLEAN
PARTNER

MELBOURNE
+61.3.9205.2025
ALAN.MACLEAN@KLGATES.COM



STUART BROADFOOT
PARTNER

SYDNEY
+61.2.9513.2512
STUART.BROADFOOT@KLGATES.COM



SIMON ASHWORTH
PARTNER

SYDNEY
+61.2.9513.2520
SIMON.ASHWORTH@KLGATES.COM



ADAM LEVINE
PARTNER

PERTH
+61.8.9216.0965
ADAM.LEVINE@KLGATES.COM

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