

Private Debt in Real Estate

- Educational Presentation #14 – Real Estate
- 05.11.2025
- Property of the Alternative Investment Society (AIS)

Section I: Foundations

Fundamentals of Private Credit

- Private debt in real estate is a major subset of the general private credit market (often used synonymously with “private debt market”)

- Non-bank lending: Capital provided by institutional investors or private funds rather than traditional banks
- Direct financing, meaning loans are made straight to companies or projects, bypassing public bond markets
- An asset class which has grown immensely in the last 20 years

Private Credit

- In real estate, private debt is a popular alternative to financing acquisitions, developments or recapitalization
- The debt is secured by the underlying property, meaning predictable income and downside protection
- There exist many private debt funds who raise money to make investments specifically into real estate

Private Debt in Real Estate

Regulation Arbitrage:

- The main reason for strong growth within the private credit sector is heavy bank regulation since the GFC making it harder for banks to compete, especially to mid-sized borrowers and to some extent also real estate borrowers
- Frameworks such as Basel IV make it more restrictive and expensive for banks to originate and hold loans
- As a result, private lenders who are not bound by the same capital requirements or regulations, can take market share even though they charge a higher spread

Core Characteristics

Tailored Structuring

- Private debt is custom-built for specific borrower needs, offering increased flexibility for both parties
- Bespoke structuring often includes stronger covenants and collateral than traditional loans, as protection for the lender

Floating-rate

- Loans are commonly tied to benchmark rates such as SOFR or EURIBOR (+ Spread), allowing interest payments to adjust with market conditions
- This provides an inflation hedge for lenders whilst securing borrowers against higher interest rates

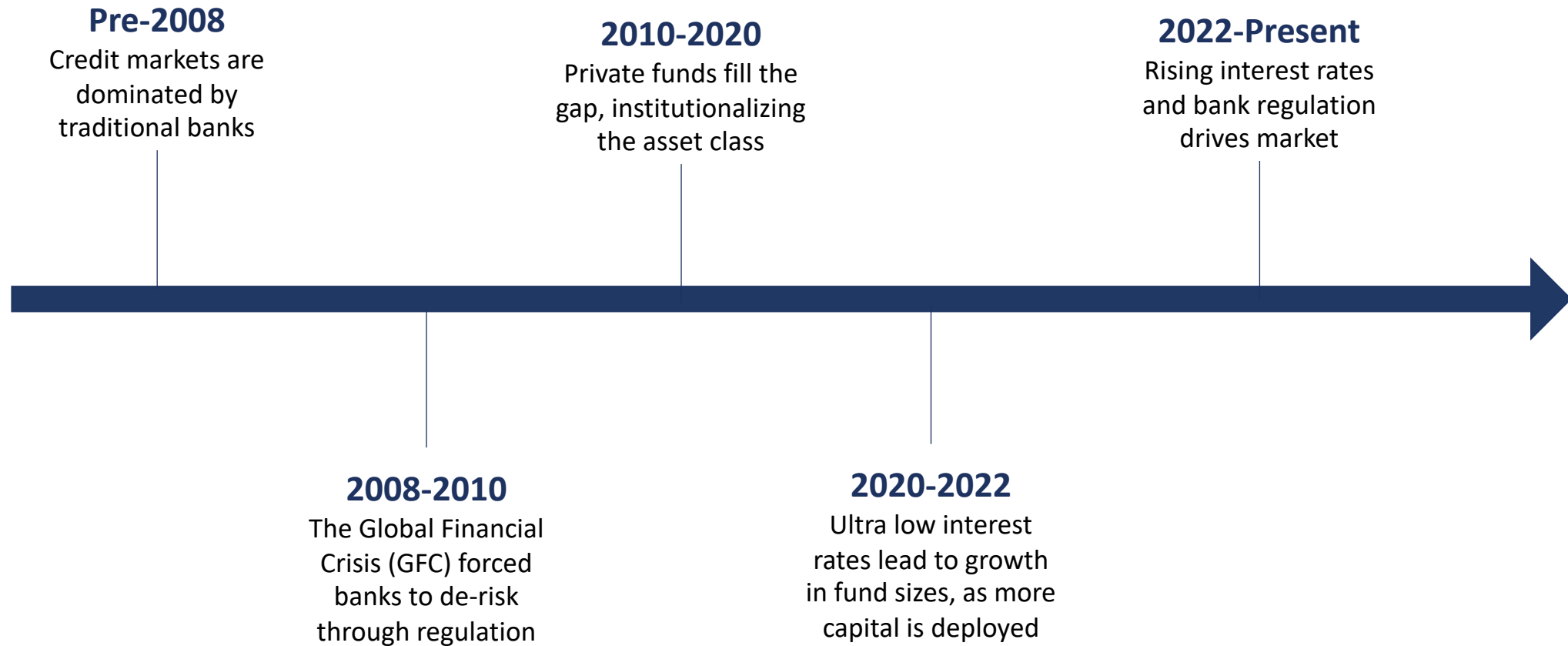
Illiquidity Premium

- As private loans are not easily sold or traded before they mature, investors are compensated with higher yields (interest rates) for accepting illiquidity

Shorter Duration and Faster Execution

- Private debt generally has a shorter duration than traditional lending, with loans typically ranging from 2-5 years
- Deals are furthermore executed quicker than traditional lending - often within weeks

Timeline of Development



Section II: Architecture

Real Estate Capital Stack

- The real estate capital stack is comprised of debt as well as equity of different types, differentiated by their risk-return profiles
- Depending on the risk profile of the real estate debt fund they focus on different tranches of debt within the capital stack
- Whilst we illustrate a typical capital stack below, structures can vary, and lenders use various metrics to determine risk

Senior Debt	Comprises the largest portion of the capital, gives lowest yield for lenders, is drawn last in capital deployment and has first repayment priority (underlying RE and CFs as collateral)	Low risk-return  High risk-return
Mezzanine Debt	Yields for subordinate debt are typically higher given its secondary collateral and lower repayment priority, meaning more risk for private lenders	
Preferred Equity	Preferred equity offers the investor a stake in the upside of the property, whilst also receiving preferential repayment conditions to reduce risk compared to sponsor equity	
Common Equity	Common equity (sponsor) holders have the highest potential upside in a project; however, they also carry the highest risk with the lowest repayment priority in case of default	

General Real Estate Debt Metrics

- To determine the size and the risk of a credit line, real estate lenders look at various metrics, some of the most prevalent of which are presented below (for more on these metrics refer to our last presentation on real estate debt):

Loan-to-Value (LTV)

- Measures the size of the loan relative to the value of the property

$$\text{LTV (\%)} = \text{Loan Amount} / \text{Appraised Property Value}$$

Loan-to-Cost (LTC)

- Usually used in development, it compares the financing to the cost of the project (hard-costs and soft-costs)

$$\text{LTC (\%)} = \text{Loan Amount} / \text{Total Project Cost}$$

Debt Service Coverage Ratio (DSCR)

- Used to determine the borrower's ability to pay based on how many times over the earnings cover the interest

$$\text{DSCR (x)} = \text{Net Operating Income (NOI)} / \text{Annual Debt Service}$$

Debt Yield

- Evaluates the return to the lender of the loan, based on the NOI relative to the loan amount

$$\text{Debt Yield (\%)} = (\text{NOI} / \text{Total Loan Amount}) * 100$$

Deal Leverage Multiple

- Deal Leverage measures the loan size relative to the income of the property, essentially being a multiple of property cash flow

$$\text{Deal Leverage} = \text{Loan Size} / \text{EBITDA}$$

Relevance in Underwriting

- Higher debt leverage multiple indicate higher risk as the property's income represents a lower percentage of the loan principle
- The multiple helps investors by allowing comparisons of loans across geographies and property types, independent of valuation assumptions
- Used along with other metrics, the deal leverage (or company leverage for a wider scope) provides a good risk assessment of an individual credit line

Example Calculation

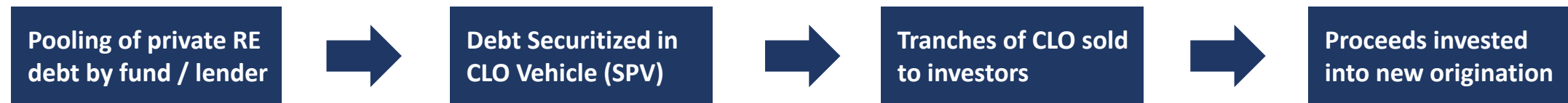
- The deal leverage is higher for bigger loans and lower cash flows generated
- An Investor is looking for financing for the acquisition of a property generating €100 million in yearly EBITDA
 1. In scenario 1, the fund provides €300 million to acquire the property at a moderate 3x deal leverage (300/100)
 2. In scenario 2, the fund provides €500 million for the acquisition at a friskier 5x deal leverage (500/100)

Lifecycle of the Debt

1. Origination	• Private debt starts at origination, where the borrower is actively looking for a lender, or lenders actively source deals with potential borrowers • Origination comprises application for debt, approval and the disbursement of funds
2. Servicing	• During the active lifetime of the loan lenders collect interest from the rent and monitor compliance • More so than public lending, private debt covenants are extensive and individual, meaning more active monitoring from lenders for potential breaches
3. Refinance or Exit (Normal Conclusion)	• Repayment in full at, or before, expiration of the debt concludes the lifecycle in most cases • As the borrower may want to payoff their debt early to redeploy assets and boost IRR, there can be prepayment penalties put in place by the lender
4. Workout or Default (Contingency)	• In a scenario where the borrower cannot repay or is in default the debt enters a workout phase • Such a phase can include restructuring the loan terms to allow for potential future repayment, forbearance (temporarily agreeing not to enforce loan obligations) or foreclosure of the property

Collateralized Loan Obligations (CLOs)

- Collateralized Loan Obligations (CLO), vehicles which pool together loans, present another way through which investors can get exposure to real estate private debt
- Lenders sell their pooled together debt in different tranches representing risk and order of re-payment, as follows:



- In real estate the CLOs are collateralized by property loans and allow managers to turn illiquid private loans into tradable securities, which allows recycling of capital and a possibility to operate at bigger scale



Bridge Loans

- Bridge loans are interim debt alternatives, used to "bridge" a gap in financing, using the property as security when quick and flexible financing is needed, typically in cases of acquisitions or renovations
- They are popular in private debt as banks do not like the less stable nature of these loans
- Much of the CLO collateral in real estate consist of bridge loans as they are short-term, high-yield and easily securitized

Sponsored vs. Sponsor-less Debt

- In private debt issuers have historically preferred sponsored debt, meaning that a separate PE firm(s) own equity in the borrower
- Though these loans provide a lower yield (usually by approximately 30 bps) than sponsor-less debt, they also provide a lower risk and are faster to execute due to the support and due diligence provided by the sponsor



Executing Sponsor-less Deals

- Due to increased competition and recent sluggish market environments in the direct lending space, sponsor-less deals might be on the rise
- Whilst such deals are more difficult to source, they can provide more attractive risk-adjusted returns, with success depending more on a lender's internal ability to navigate deal structuring
- Risk mitigation is a longer process in sponsor-less deals with funds having to set up tight covenants regarding the property performance, collateral packages, leverage limits and cash leakage constraints, as well as making sure borrowers have sufficient skin-in-the-game

Section III: Back-Leverage on Assets

Understanding Back Leverage

- Back leverage allows real estate debt funds to amplify returns by financing a portion of loan investments with additional debt
- This leverage structure increases the fund's equity multiple and IRR, as the same underlying exposure is financed with less capital
- However, it raises refinancing and credit risk, as the fund must meet covenants and margin calls if collateral weakens

For example, to the right:

- The debt fund initially purchases a \$65mn whole loan on a \$100mn property
- By introducing bank-level back leverage, the fund borrows \$45mn against the loan portfolio, reducing its own invested capital to \$20mn, leading to an enhanced ROE

Advance Rate	The advance rate is the percentage of a loan's value that a third-party lender (usually a bank) is willing to finance against the collateral's total value (≈70% in our example to the right)
---------------------	--

1. THE UNDERLYING CRE ASSET

Property Value: \$100mn

2. WHOLE LOAN WITHOUT LEVERAGE

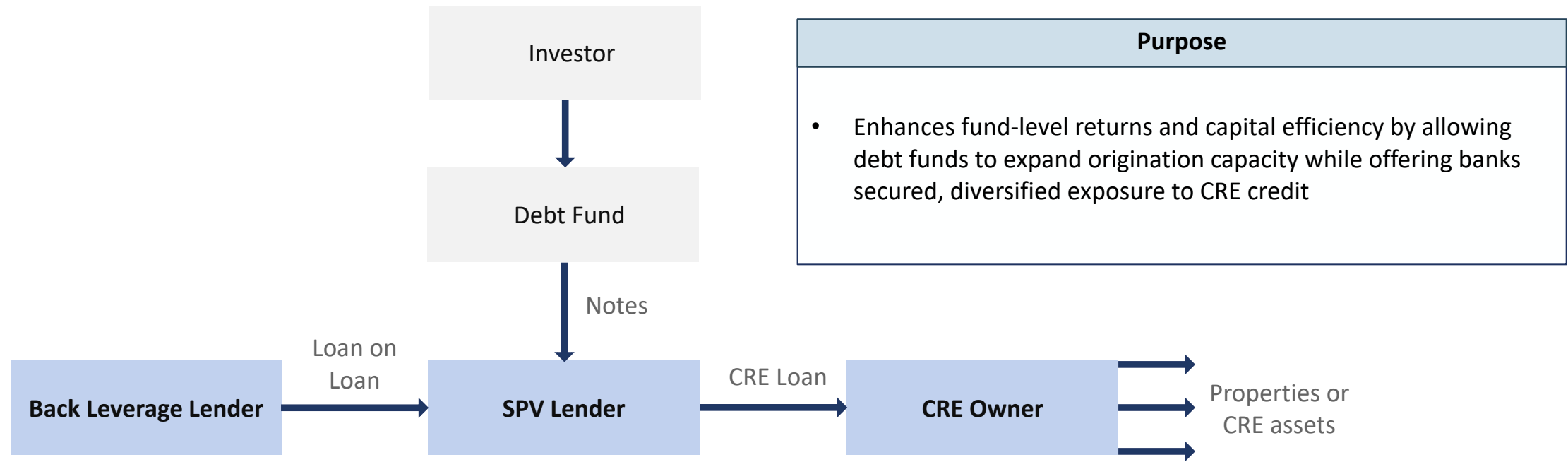
Underlying Borrower Equity: \$35mn	Private Loan Value: \$65mn
--	-------------------------------

3. WHOLE LOAN WITH BACK LEVERAGE

Underlying Borrower Equity: \$35mn	Debt Fund Capital: \$20mn	Back Leverage from Bank: \$45mn
--	---------------------------------	---------------------------------------

What Is Loan-on-Loan?

- Loan-on-loan back leverage refers to a specific form of back-leverage in which a lender, typically a bank or institutional investor provides financing to a real estate debt fund that is secured by the fund's own portfolio of loans
- In other words, the lender extends a loan against loans: the fund pledges its existing real-estate-backed debt positions as collateral to obtain additional capital for new originations or portfolio expansion

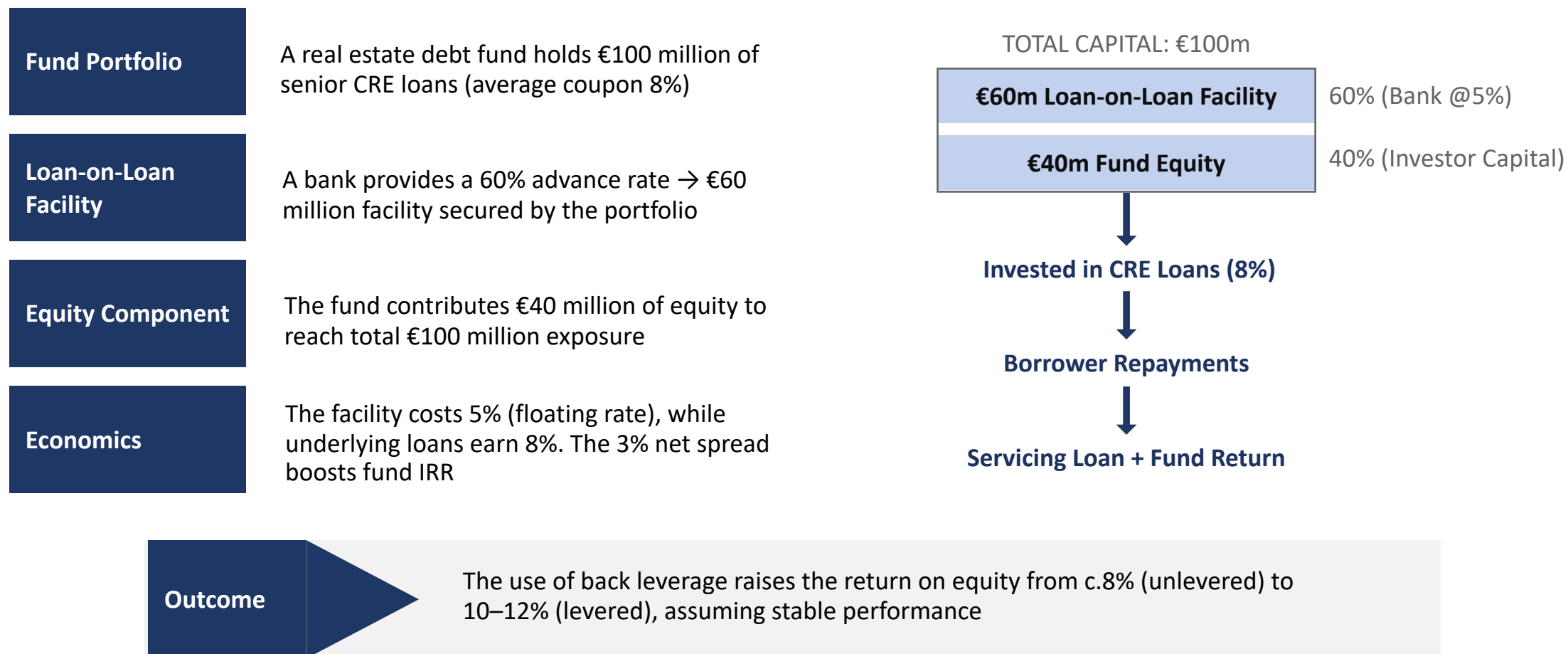


Mechanics of Loan-on-Loan Structures

- Loan-on-loan facilities are typically secured, revolving credit lines provided by banks or institutional lenders to real estate debt funds, these facilities allow funds to finance a portion of their existing loan portfolios and recycle capital into new lending opportunities

Collateral	• Typically consists of the fund's performing real estate loans (senior or mezzanine) • These loans are pledged as security for the facility • Collateral eligibility depends on loan performance, diversification, and property type (core office, logistics, etc.)
Advance Rate	• Lenders provide financing for 50–70% of the eligible loan portfolio value • The advance rate reflects loan quality, seniority, and diversification • The remaining unfinanced portion ("haircut") acts as a risk buffer protecting the lender
Facility Type	• Usually revolving, allowing new capital to be drawn as loans are repaid • Enables continuous deployment of capital and efficient balance sheet management
Interest & Tenor	• Floating-rate structure (e.g., EURIBOR/SOFR + spread) • Facility maturities typically 2–5 years, aligned with the loan portfolio's duration • Interest resets periodically, mitigating duration risk for the lender

Example of Loan-on-Loan Effect



Why Banks Offer Loan-on-Loan Financing

Regulatory and Capital Efficiency

- Under Basel IV, direct CRE loans carry high risk-weights and capital charges
- Loan-on-loan structures are treated more like secured corporate credit, giving banks lower regulatory capital requirements
- This enables banks to maintain indirect exposure to real estate credit even as traditional CRE lending shrinks

Stable Risk-Adjusted Returns

- Floating-rate structures provide protection against interest-rate volatility
- Collateralized by diversified, performing CRE loans → lower default risk
- Short-term facilities (2–5 years) generate predictable income with limited asset-management effort

Market Leaders



Key Terms and Risk Controls

- To manage risk and maintain portfolio stability, lenders apply strict eligibility, monitoring, and covenant frameworks when providing loan-on-loan back leverage → These measures ensure that exposure remains secured and well-diversified

Eligibility Criteria

Only performing, senior-secured CRE loans qualify as collateral

- Excludes non-performing or construction loans (higher volatility)
- Often limited to specific geographies or property types (e.g., core office, logistics)

Advance Rate & Haircut

Determined by risk profile, diversification, and loan seniority

- Core senior loans → 70% advance rate
- Value-add → 50% advance rate

The unfinanced portion (haircut) serves as protection buffer for the lender

Covenants & Triggers

- LTV caps at both portfolio and individual loan level
- Concentration limits (sector, borrower, geography)
- DSCR / ICR tests to monitor cash flow coverage
- Margin calls if collateral value or performance drops below threshold

Maturity & Monitoring

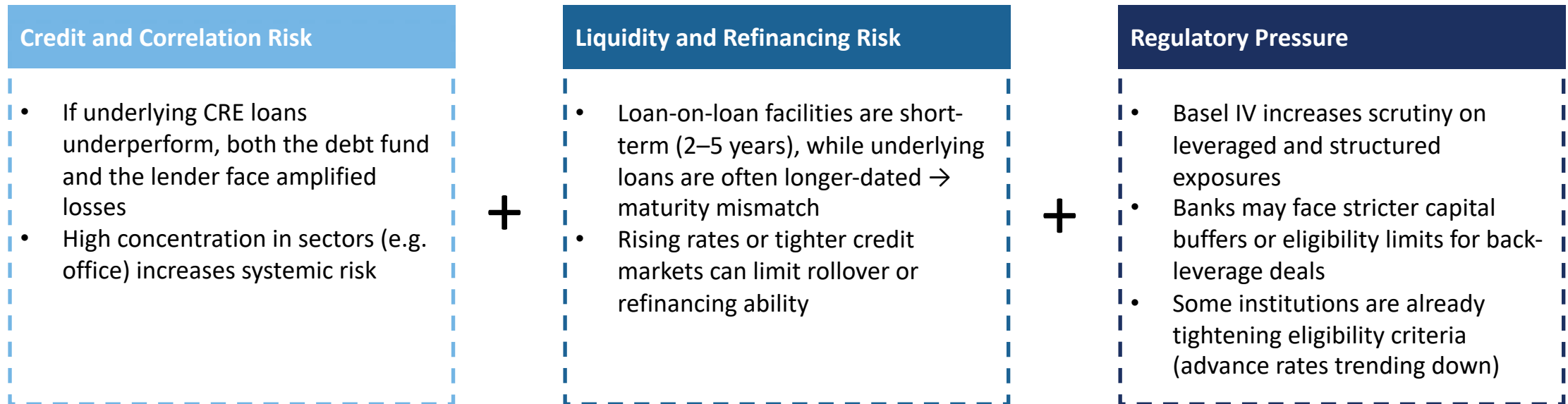
- Facility term usually 2–5 years, matching average loan durations
- Ongoing reporting and revaluation of collateral
- Lenders may perform regular audits of underlying loan books

Outlook

- While back leverage enhances returns and capital efficiency, it introduces additional risks related to leverage, liquidity, and regulatory tightening

“Going into 2025, we expected the number of real estate lending opportunities to continue growing and so far, they have. Our global lending pipeline has hit a high-water mark twice so far this year.”

– KKR Real Estate Credit team, May 2025



Repurchase Agreements

- Repo (Repurchase) agreements are another way for funds to use assets on hand to unlock more liquidity through back-leverage
- These agreements are essentially buy-and-lease-back contracts but for CRE debt, where banks buy debt at discounted value with the fund's promise to buy it back after a certain period, for a slightly higher fee – they are legally sales, but effectively loans

- **Example of repo agreement :**

1. A debt fund holds a commercial real estate (CRE) loan worth €100 million



2. The fund sells this loan to a bank for €90 million, with the promise of repurchasing it one year later



3. Whilst the loan is owned by the bank on paper, the fund continues to collect interest payments



4. After one year the debt fund repurchases the debt for €92.7 million, effectively paying €2.7 million (3%) in financing cost

- The main risk of repo agreements is in the collateral value of underlying assets (the debt in this case) declining which triggers margin calls, forcing funds to sell assets - an effect amplified in illiquid, mark-to-market CRE loans

Comparing Structures

- Whilst being under the same umbrella of asset backed back-leverage, loan-on-loan structures are more widely used with all banks in the back-leverage market using this tool and only 40% using repurchase agreements

Loan-on-Loan	Repurchase Agreements
• Secured loan between bank and fund, where the fund keeps ownership of the underlying loan • Generally medium term (2-5 years) • Slightly higher cost due to duration and executional complexity • Banks setting the advance rate and covenants reduces fund risk to daily mark-to-market valuations of collateral • Best suited for long-term expansion of origination capacity	• Sale-and-repurchase contract where the bank temporarily takes ownership of the underlying loan • Short-term (3-12 months) • Cheaper financing generally • The discount paid by banks limits credit risk but exposes fund to potential margin call • Better suited for short-term liquidity with the low-volatility collateral

Section IV: Syndication

What is Syndication?

- Syndication refers to the process where a lender (or fund) sells a portion of an existing loan exposure to other investors or banks
- It allows the original lender to free up capital, reduce exposure, and recycle proceeds into new lending opportunities

Syndication	Back leverage
→ risk is transferred to another investor	→ risk is financed by another lender



Syndication typically occurs **post-origination** (after the loan is closed), while back leverage is structural (at fund level)

Why Banks Buy Syndicated Loans

- Banks typically enter post-closing, once projects reach key de-risking milestones (e.g., lease signed, construction progress, stabilized cash flows)
- At this stage, the loan's risk-return profile aligns with bank mandates, lower risk, predictable income, and regulatory capital efficiency
- Debt funds originate early-stage or transitional risk, then sell down (syndicate) portions once the asset becomes bankable
- This allows banks to access secured, yield-enhanced exposure without taking development or leasing risk

Why Funds Syndicate Loans

Capital Recycling

- 1 Syndication enables the fund to free up capital once a loan has partially de-risked and redeploy it into new, higher-yield opportunities

IRR Enhancement

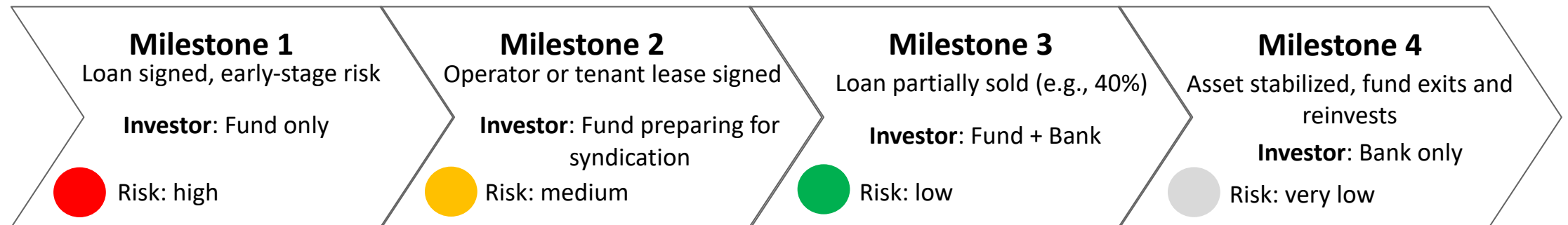
- 2 By selling down part of a stabilized exposure, funds can realize early gains and shorten the capital duration, directly improving fund-level IRR

Risk Management

- 3 As leasing or permitting risks are mitigated, the fund can transfer part of the exposure to banks or institutional lenders, reducing concentration and downside risk

Portfolio Optimization

- 4 Syndication helps maintain a balanced risk-return profile across the portfolio; funds can rotate out of lower-yield stabilized loans into fresh originations



Syndication in Practice: Office to Serviced Apartments Conversion

- **Asset:** Office property under conversion to serviced apartments
- **Zoning:** Remains commercial use, no new residential permit required
- **Initial risk:** No signed operator lease at entry; exposure considered transitional and non-bankable
- **Fund role:** Originated the senior loan before lease signing, targeting higher spread to compensate for early-stage risk



Process

Origination (Milestone 1)

Fund originates €50m loan, project at concept stage, no lease

De-Risking (Milestone 2)

Operator lease signed → project becomes bankable

Syndication (Milestone 3)

Fund sells 40% of loan to a bank, reducing exposure to €30m

Exit & Reinvestment (Milestone 4)

Remaining bond is sold, and proceeds are used for reinvestment

Stage	Fund Exposure	Yield	Key Outcome
Entry	100% (€50m loan)	9.0%	Pre-lease, high risk
After syndication	60% (€30m)	8.2%	Lower risk, reduced exposure
Reinvestment	0% (€0m) in original loan	10.0%	New origination improves fund IRR

Section V: Practice Problems

Practice Problems

The following practice problems can be used as interview prep – all mental math (no calculator allowed)

1. You finance the acquisition of a property which has an appraised value of €500 million with €300 million worth of debt. What is the LTV ratio of the acquisition?
2. Using the same building, what is the Deal Leverage given that the EBITDA per year is 10% of the appraised value of the property?
3. A fund acquires a property for €200 million, using €120 million of debt. The property has an NOI of 9% of the purchase price and the interest rate on the loan of 5%. What is the DSCR for this property?
4. A debt fund originates a €160 million private loan which it wants to back-leverage. It uses an advance rate of 75%. How much of the debt is financed by the debt fund's own capital?
5. A debt fund originates a loan for a €50 million property at an LTV of 60%. If the fund uses €15 million of its own capital to fund the transaction and the rest through back-leverage, what is the advance rate used?
6. A bank offers 70% advance rate on a €100 million private CRE debt. If the debt value falls 12.5%, what's the new effective advance rate?
7. A debt fund sells a €100 million loan to a bank at 70% of face value and agrees to repurchase in one year for €72.1 million. If the fund simultaneously earns 8% on those loans, what's the spread to the financing cost of the repo agreement?
8. {Advanced} A fund holds €100 million of CRE loans yielding 8%. A bank provides 60% (advance rate) loan-on-loan financing at 5%. What's the fund's levered return on equity?

Answers - Practice Problems (pt.1)

The following practice problems can be used as interview prep – all mental math (no calculator allowed)

1. You finance the acquisition of a property which has an appraised value of €500 million with €300 million worth of debt. What is the LTV ratio of the acquisition?

Loan Size = €300 million , Appraised Value = €500 million

$LTV = \text{Loan Size} / \text{Appraised Value} = 300 / 500 = 60\%$

2. Using the same building, what is the Deal Leverage given that the EBITDA per year is 10% of the appraised value of the property?

Loan Size = €300 million, Appraised Value = €500 million

$EBITDA = 0.1 * \text{Appraised Value} = €50 \text{ million}$

$\text{Deal Leverage} = \text{Loan Size} / EBITDA = 300/50 = 6x$

Answers - Practice Problems (pt.2)

The following practice problems can be used as interview prep – all mental math (no calculator allowed)

3. A fund acquires a property for €200 million, using €120 million of debt. The property has an NOI of 9% of the purchase price and the interest rate on the loan of 5%. What is the DSCR for this property?

Acquisition Cost = €200 million, Loan Size = €120 million

NOI = $0.09 * \text{Acquisition Cost} = 0.09 * 200 = \text{€18 million}$

Annual Debt Service = $\text{Interest Rate} * \text{Loan Size} = 0.05 * 120 = \text{€6 million}$

DSCR = $\text{NOI} / \text{Annual Debt Service} = 18 / 6 = 3x$

4. A debt fund originates a 160€ million private loan which it wants to back-leverage. It uses an advance rate of 75%. How much of the debt is financed by the debt fund's own capital?

Debt Size = €160 million, Advance Rate = 75%

Bank Back-Leverage Financing = $\text{Debt Size} * \text{Advance Rate} = 160 * 0.75 = \text{€120 million}$

Fund Capital Financing = $\text{Total Debt} - \text{Bank Financing} = 160 - 120 = \text{€40 million}$

Answers - Practice Problems (pt.3)

The following practice problems can be used as interview prep – all mental math (no calculator allowed)

5. A debt fund originates a loan for a €50 million property at an LTV of 60%. If the fund uses €15 million of its own capital to fund the transaction and the rest through back-leverage, what is the advance rate used?

Property Value = €50 million, LTV = 60%

Loan Size = Property Value * LTV = 50 * 0.6 = €30 million

Bank Back-Leverage Financing = Total Debt – Fund Capital Used = 30 – 15 = €15 million

Advance Rate = Bank Loan / Collateral Value (The Debt) = 15 / 30 = 50%

6. A bank offers a 70% advance rate on a €100 million private CRE debt. If the debt value falls 12.5%, what's the new effective advance rate?

Debt Value at Origination = €100 million, Back-Leverage at Origination = 70%

Value of Back-Leverage at Origination = 100 * 0.70 = €70 million

New Value of Private Debt = 100 * 0.875 = €87.5 million

New effective Advance Rate = 70 / 87.5 = 80%

Answers - Practice Problems (pt.4)

The following practice problems can be used as interview prep – all mental math (no calculator allowed)

7. A debt fund sells €100 million of loans to a bank at 70% of face value and agrees to repurchase in one year for €72.1 million. If the fund simultaneously earns 8% on those loans, what's the spread to the financing cost of the repo agreement?

Total Purchase of Bank = €70 million, Total Repurchase of Fund = €72.1 million, Interest Rate on Original Debt = 8%

Cost of the Repo Agreement = Fund Repurchase cost – Bank Purchase cost = $72.1 - 70 = €2.1$ million

Effective Financing Interest Rate = Cost of Agreement / Price = $2.1 / 70 = 3\%$

Spread = Interest Rate on Original Debt – Financing Interest Rate = $8\% - 3\% = 5\%$

8. {Advanced} A fund holds €100 million of CRE loans yielding 8%. A bank provides 60% (advance rate) loan-on-loan financing at 5%. What's the fund's levered return on equity?

Original total debt (Interest Rate) = €100 million (8%), Bank Back-Leverage total debt (Interest Rate) = €60 million (5%)

Equity used in Loan = Original Debt – Back-Leverage = $100 - 60 = €40$ million

Cost of leverage = Back-Leverage debt * Interest Rate of Back-Leverage = $60 * 0.05 = €3$ million

Total Return = Revenue from originated debt – Cost of Back-Leverage = $100 * 0.08 - 3 = €5$ million

Levered ROE = Return / Equity = $5 / 40 = 12.5\%$



ESCP Alternative
Investment Society