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Principal Asset Management℠

PRINCIPAL REAL ESTATE

Four ways to potentially enhance returns through leverage

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Leverage is a strategy designed to enhance an investment's returns. In this paper, we explore leverage with a focus on one piece of the capital stack: senior debt in the transitional space. These are first mortgage loans secured by properties that are currently in or will soon be in a state of transition. They provide sponsors shorter-term financing to facilitate property acquisitions and repositioning.

AT-A-GLANCE

- There are a variety of ways to finance senior mortgage loans. Using 100% debt fund equity is always an option, of course, but utilizing leverage enables more output for a given input – in other words, potential enhanced returns.
- Most debt fund and mortgage REIT managers in today's senior mortgage space utilize leverage in order to potentially enhance returns. There are broadly four types of leverage commonly utilized:
  - Note-on-note financing and warehouse/REPO facilities are forms of third-party leverage, which involves borrowing against equity to enhance returns.
  - A-note sales and commercial real estate collateralized loan obligations (CRE CLO) are forms of structured leverage, which involves carving up the loan or portfolio, divesting the most conservative position(s) and retaining the less conservative position(s) for a higher yield.

EXHIBIT 1: Four ways to enhance returns though leverage

	Leverage	Collateral	Terms
Third-party leverage			
Note-on-note financing	Advance rate	Single loan	• Matched term • Non-recourse • Not subject to margin calls
Warehouse/REPO facility	Advance rate	Pool of loans	• Historically not precisely matched term but that is changing • Historically included spread mark provisions but that is changing
Structured leverage			
A-note sale	Retained B-note	Single loan	• Matched term • Non-recourse • Not subject to margin calls
Commercial real estate collateralized loan obligations (CRE CLO)	Retained bottom tranche	Pool of loans	• Matched term • Non-recourse

Third-party leverage

Third-party leverage involves using a combination of equity and borrowed money to potentially enhance returns, which come from the difference between the fund yield and the interest on the financed portion. In this paper we cover two types of third-party financing structures: note-on-note and warehouse facilities.

Note-on-note financing

Note-on-note financing involves financing a mortgage where the mortgage note is the collateral. Essentially we're borrowing some amount (the advance rate) supplemented by debt fund equity in order to make the investment. Many large financial institutions, including investment banks, money center banks, regional banks and some insurance companies, offer this type of program.

EXHIBIT 2: Note-on-note leverage example

Without leverage

$100M debt fund equity → **$100M unlevered investment**
Annual yield $6M
SOFR +350 bps

6% ($6M)
Net earnings on debt fund equity

With leverage

$25M debt fund equity

$75M facility
75% advance rate
Annual borrowing cost **$3.75M** (SOFR +250 bps)

→ **$100M levered investment**
Annual yield $6M
SOFR +350 bps

9% ($2.25M)
Net earnings on debt fund equity

Note: For illustrative purposes only. Calculations assume secured overnight financing rate (SOFR) at 4.00%.

The value of note-on-note leverage is the same principle as any kind of third-party leverage – higher net earnings on levered investments than non-levered investments. Consider the example shown in Exhibit 2. We could do an all-equity deal. If our coupon is 350 basis points (bps)* above the benchmark (SOFR), then our annual return on the debt fund equity is 6%. Alternatively, we could leverage $25 million in equity to borrow $75 million (a 75% advance rate). We earn the same 6% on the loan; subtracting interest at SOFR plus 250 basis points, our return on the debt fund equity is 9%.

*A basis point is a unit of measure used to indicate percentage changes in financial instruments.

Warehouse/repurchase (REPO) facilities

A warehouse/REPO facility functions in essentially the same way as note-on-note, but the credit line is cross-collateralized by a pool of loans rather than a single loan. Generally the same providers of note-on-note financing also provide warehouse/REPO facilities: large financial institutions, including investment banks and insurance companies.

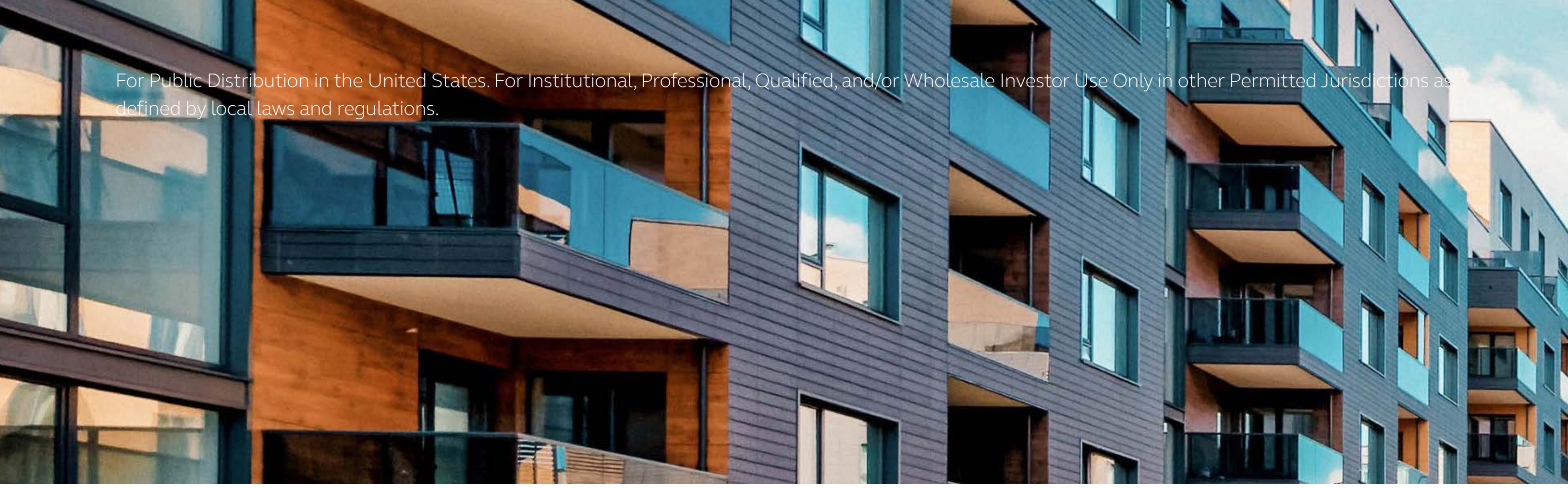


EXHIBIT 3: Warehouse/REPO facility leverage example

Warehouse $250M Total Capacity

$50M Investment 1
Annual yield
SOFR+300 bps
→ **$40M facility** (80% advance rate)
Annual Funding cost
SOFR +200
$10M debt fund equity
SOFR+700

$50M Investment 2
Annual yield
SOFR+290 bps
→ **$37.5M facility** (75% advance rate)
Annual Funding cost
SOFR +190
$12.5M debt fund equity
SOFR+590

$50M Investment 3
Annual yield
SOFR+275 bps
→ **$30M facility** (60% advance rate)
Annual Funding cost
SOFR +160
$20M debt fund equity
SOFR+448

$50M Investment 4
Annual yield
SOFR+280 bps
→ **$35M facility** (70% advance rate)
Annual Funding cost
SOFR +170
$15M debt fund equity
SOFR+537

$142.5M used

$107.5M unused

Note: For illustrative purposes only.

The value of warehouse/REPO facility leverage is the same in principle as any kind of third-party leverage – higher net earnings on levered investments than non-levered investments. Essentially we take a group of loans and pledge them to the third-party facility, and in turn receive an advance rate at a cost of capital lower than our initial mortgage rate. Consider the example shown in Exhibit 3. Average net earnings across the four investments would be 286 basis points above SOFR (5.36% if SOFR is at 2.5%) without leverage, and 550 basis points above SOFR (8.0%) with leverage.

Terms, spread marks, margin calls—the evolution of warehouse/REPO facilities

Warehouse/REPO facilities have not historically been precisely matched term. For example, we commonly structure a loan as a 3-year term with two 1-year extensions. But the facility was commonly structured as a 3-year term with one 1-year extension at the facility provider's discretion. The original terms matched, but not the extensions; the facility provider could make a margin call before the end of the loan term.

Some facility providers have softened their position on term matching. With a matched term facility, we can put loans on the line (by borrowing against the facility) during the term period, and the provider will extend the entire facility to match the term of the last loan put on the line. This way, we're not at risk of getting margin called for market events that are outside of our control. (We can still get called if there's a credit event at the asset level, which is somewhat tied to market events.)

Other third-party leverage terms have changed over time as well, including spread mark provisions, which allow banks to make a margin call when spreads widen (which deteriorates the value of the loan). This was a significant problem during the global financial crisis, when spreads were gapping very aggressively; banks were making margin calls, and investors were forced to write off significant value.

Mitigating the risk of a margin call before the end of the loan term is essential. So when facilities came with spread mark provisions and without matched terms, risk mitigation could be accomplished through note-on-note financing, or structured leverage such as subordinate debt or CRE CLO executions – which have typically been matched term and less susceptible to spread volatility. Facilities which structure without spread marks are not uncommon and a number are offering matched terms. Because of this evolution we can execute across a number of loans (rather than having to execute one-by-one) without worrying about margin calls for term or spread provisions. (Again, margin is still part of the structure; we can be called for credit events at the asset level.)

Structured leverage

Where third-party leverage involves borrowing money to enhance returns, structured leverage involves carving up the loan or loan portfolio and divesting the most conservative positions, retaining the less conservative position(s). Enhanced returns come from higher yields on the retained portion. In this paper we cover two types of structured leverage: A-note sales and commercial real estate collateralized loan obligations (CRE CLO).

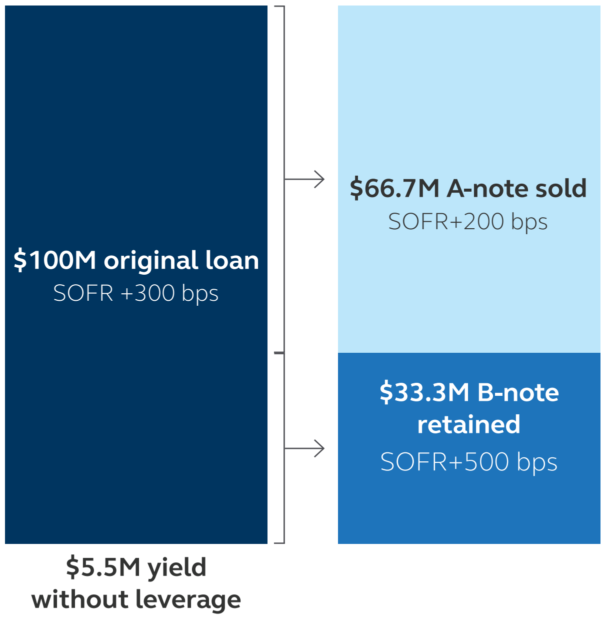
A-note sale

An A-note sale consists of making a whole loan, splitting off a more conservative portion, selling that portion to an A-note buyer, and retaining the B-note* for a higher return profile. The A-note portion carries a lower yield than the whole loan, while the retained portion carries a higher yield; the blended rate to the borrower doesn't change. Buyers of A-notes are typically banks, insurance companies, or other financial institutions. An A-note sale is matched term, non-recourse, non-margin call financing.

With an A-note sale, we're manufacturing a subordinate position in order to enhance returns. We've subordinated the B-note which pays a premium because it's the riskier portion of the loan.

*Using the A-note terminology is market convention. However, in reality the senior portion is a mortgage (not an A-note) and the junior portion is subordinate (not a B-note).

EXHIBIT 4: A-note sale structured leverage example



Consider the example shown in Exhibit 4 . The original loan is for $100 million at a rate of 300 basis points above benchmark (SOFR). We split off the most conservative portion, which becomes the A-note. Because it is the most conservative portion of the loan, the A-note yields a lower rate; in this example, 200 basis points above SOFR. That A-note essentially becomes our leverage for subordinating the B-note, which carries a higher rate; 500 basis points above SOFR. (The loan retains the original blended rate.) Enhanced returns come from retaining the higher-yield B-note, as well as from the ability to then reinvest the proceeds from the A-note sale.

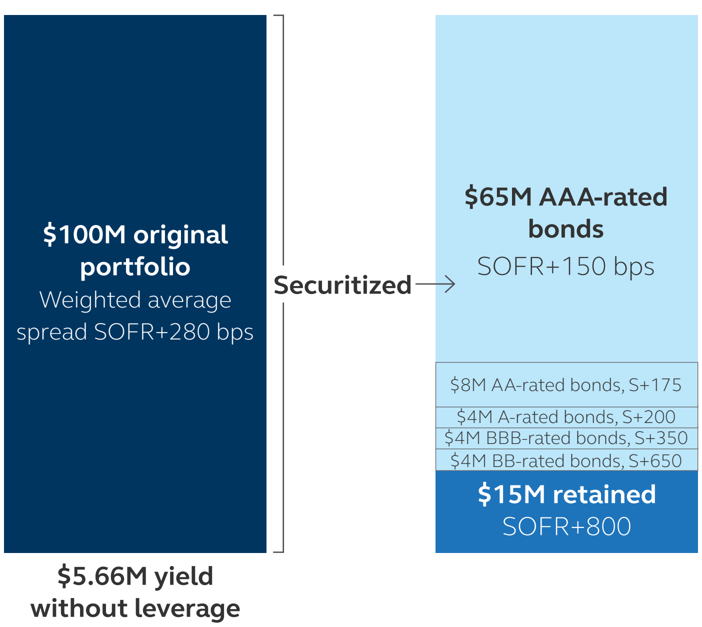
Note: For illustrative purposes only. Calculations assume SOFR at 4.00%.

Commercial real estate collateralized loan obligations (CRE CLO)

A commercial real estate (CRE) collateralized loan obligation (CLO) involves the issuance of bonds via a securitization that is collateralized by a pool of mortgages. The loans servicing as collateral in CRE CLOs are floating rate, often transitional properties, usually with a duration of three to five years.

Similar to how we manufacture a mezzanine position in order to enhance returns with an A-note sale, with CRE CLO we're also splitting the original loan portfolio – this time into tranches rather than a single A-note – and we're retaining the bottom most portion (usually the bottom 10-20%). That retained tranche carries a higher yield.

EXHIBIT 5: CRE CLO structured leverage example

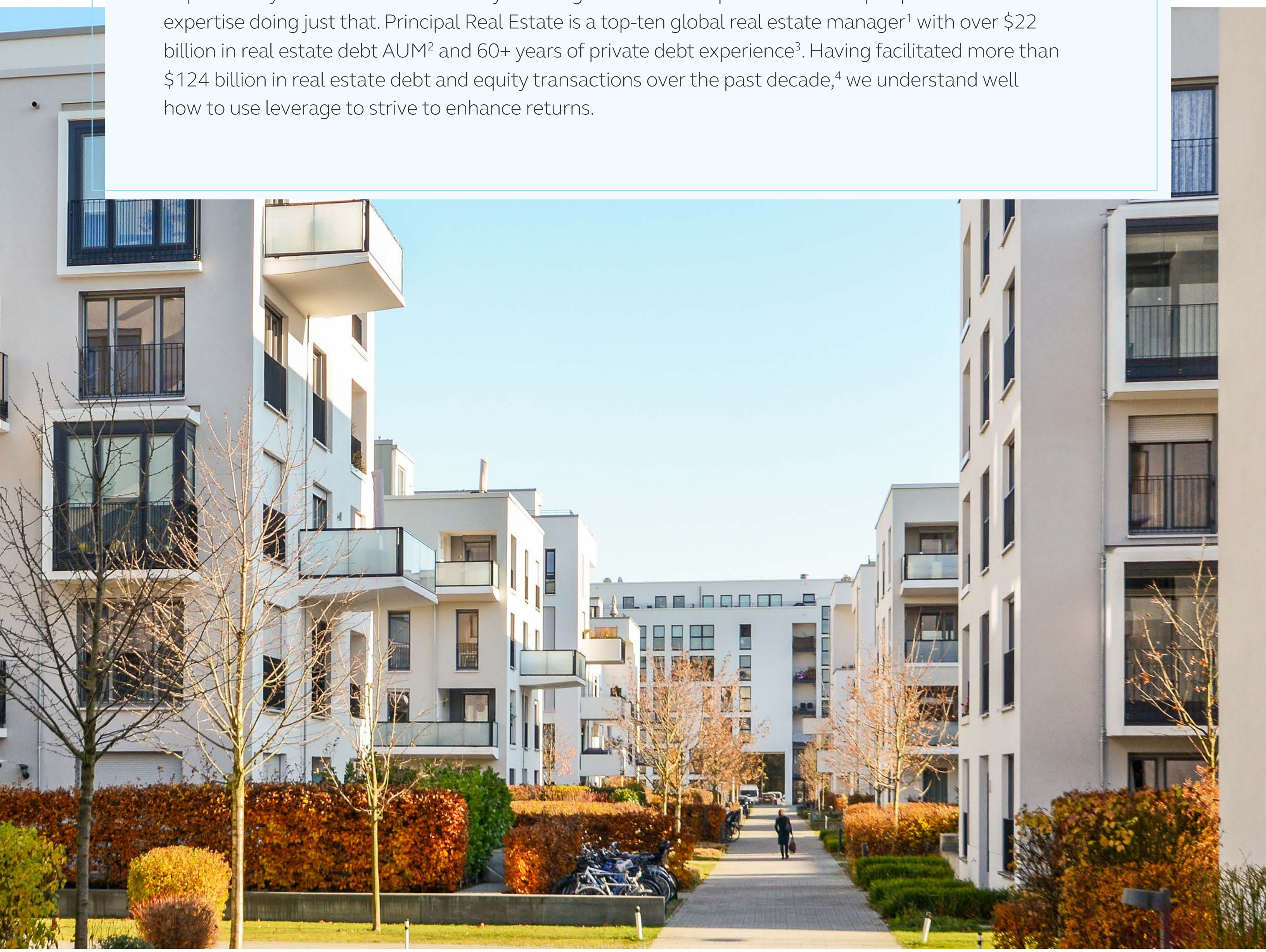


Consider the example shown in Exhibit 5. The original loan portfolio totals $100 million at a weighted average rate of 316 basis points above benchmark (SOFR). We securitize that into six tranches with varying yields, selling the topmost five tranches. Those essentially become our leverage for the retained portion, which carries a higher rate; 800 basis points above SOFR in this example. Enhanced returns come from retaining the higher-yield tranche, as well as from the ability to then reinvest the proceeds from the sale of the other tranches.

Note: For illustrative purposes only. Calculations assume SOFR at 4.00%.

CONCLUSION

There is a wide range of considerations to be made when deciding how to utilize leverage in order to potentially enhance returns. The key is having an investment partner with deep experience and expertise doing just that. Principal Real Estate is a top-ten global real estate manager[1] with over $22 billion in real estate debt AUM[2] and 60+ years of private debt experience[3]. Having facilitated more than $124 billion in real estate debt and equity transactions over the past decade,[4] we understand well how to use leverage to strive to enhance returns.



[1] Managers ranked by total worldwide real estate assets (net of leverage, including contributions committed or received, but not yet invested; REOCs are included with equity; REIT securities are excluded), as of 30 June 2024. "The Largest Real Estate Investment Managers," Pensions & Investments, 7 October 2024.

[2] As of December 31, 2024.

[3] Experience includes investment management activities of predecessor firms beginning with the investment department of Principal Life Insurance Company. Principal Real Estate became registered with the SEC in November 1999.Activities noted prior to this date above were conducted beginning with the real estate investment management area of Principal Life Insurance Company and later Principal Capital Real Estate Investors, LLC, the predecessor firm to Principal Real Estate Investors, LLC.

[4] As of December 31, 2024. Excludes public REIT transaction volume.

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Investing involves risk, including possible loss of Principal. Past Performance does not guarantee future return. All financial investments involve an element of risk. Therefore, the value of the investment and the income from it will vary and the initial investment amount cannot be guaranteed. Potential investors should be aware of the risks inherent to owning and investing in real estate, including value fluctuations, capital market pricing volatility, liquidity risks, leverage, credit risk, occupancy risk and legal risk. All these risks can lead to a decline in the value of the real estate, a decline in the income produced by the real estate and declines in the value or total loss in value of securities derived from investments in real estate. The use of leverage increases investment exposure and has the potential to magnify losses. Investments in leveraged loans, middle market loans, and mezzanine debt, second liens, are subject to various risk factors, including credit risk, liquidity risk and interest rate risk. Commercial mortgage lending entails a degree of risk that is typically for those who can who fully understand and can bear the risks associated with such strategy. Any commercial mortgage is subject to the basic risk of lending and direct ownership of commercial real estate mortgages - borrower default on the loan and declines in the value of the real estate collateral. Defaults can be complicated by borrower bankruptcy and other litigation including the costs and expenses associated with foreclosure which can decrease an investor's return.

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