REAL ESTATE

Real Estate Credit: Complex Market, Simple Equation

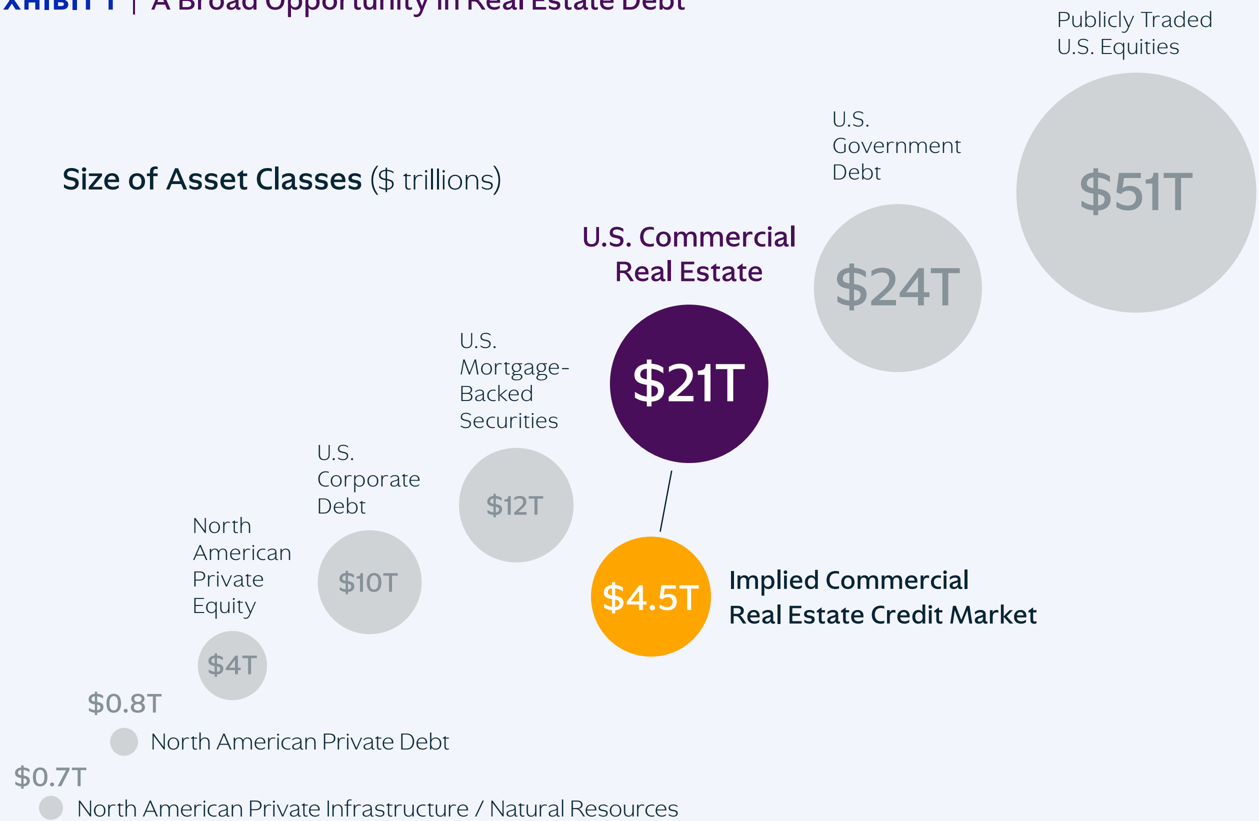
Commercial real estate credit is a large, complex asset class with attractive potential benefits for investors. In this guide to commercial real estate credit investing, we'll cover the following topics.

- What exactly is real estate credit, and what are the potential benefits of investing in it?
- What roles do credit and equity play in a real estate transaction?
- How are real estate loans securitized?

An Overview of Commercial Real Estate Credit

The commercial real estate credit universe is built on loans. These loans are typically mortgages with a senior position in the capital structure and help fund commercial property purchases, finance new development, and allow existing property owners to refinance and recapitalize their real estate holdings. Lenders may include banks, insurance companies, government-sponsored enterprises, asset management firms, or specialty real estate lenders. Real estate credit is a large and complex asset class *(Exhibit 1)*, with many potential benefits for investors.

EXHIBIT 1 | A Broad Opportunity in Real Estate Debt



Note: Equities data as of March, 29, 2022. Source: Bloomberg. Note: Fixed Income data as of Q4-2022. Source: SIFMA, Bloomberg, The Federal Reserve, US Agencies, US Treasury. Note: CRE data as of Q2-2021. Source: Nareit, CoStar. Green Street. Note: Estimates of private markets assets are as of Q4 2021. Source: McKinsey & Company, Preqin. Real estate credit market data source: Mortgage Bankers Association as at March 15, 2023.

Why Invest in Commercial Real Estate Credit?

Potential benefits to an investment portfolio may include:

- Diversification to stocks and bonds
- Steady stream of income, with yields that are attractive relative to other fixed income investments
- Downside protection
- May help to mitigate the impact of inflation and rising rates

Note: Unless indicated, the above reflects the current market views, opinions and expectations of KKR based on its historic experience and other analysis. Historic market trends are not reliable indicators of actual future market behavior or future performance which may differ materially, and are not to be relied upon as such.

Understanding the Roles of Equity and Credit in Commercial Real Estate

Most real estate transactions have two components: debt and equity. It is important to understand how they relate to each other and the roles they typically play in a transaction.

The Real Estate Transaction Equation

EXHIBIT 2 | The Simple Addition of Buying a Home

Down Payment **(EQUITY)** + Mortgage **(DEBT)** = Gross Property Value

Real estate transactions can be complex, but they are all governed by a very simple equation *(Exhibit 2)*. When someone wants to buy a piece of property, they will typically invest some of their own money and borrow the rest of the amount they need to purchase the property. The buyer's money is the equity, and the loan is the debt or mortgage.

Buying a home is a familiar process that translates well to more complex real estate transactions. The homeowners make a down payment, which represents the equity portion of the transaction, and borrow the rest of the money from a mortgage lender–let's say a bank–which is the debt. The homeowner pays off the original amount of the loan, or the mortgage's principal, plus interest payments based on an agreed-upon interest rate, in regular installments over a fixed term. The lender makes money on the interest payments.

Before agreeing to lend to a potential homeowner, the lender will review their income, savings, and credit history to determine how likely they are to repay in full at the end of the mortgage's term, which is typically 30 years. The lender may offer stricter terms to compensate for the increased risk of lending to less creditworthy borrowers, including charging higher interest rates or requiring a larger down payment.

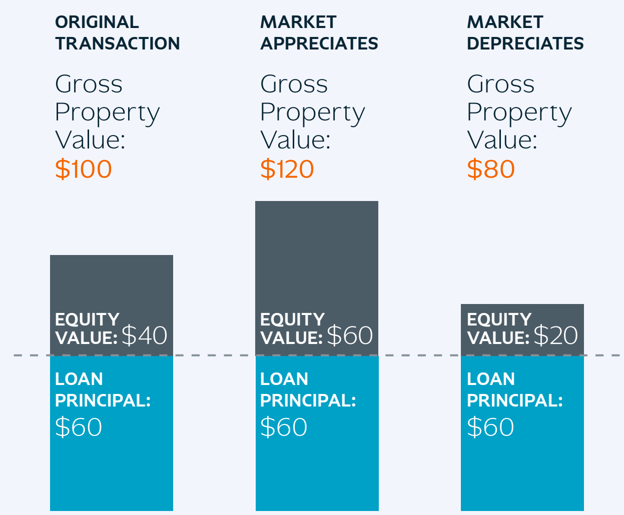
Both the equity holder (the homeowner) and the debt holder (the lender) have an interest in the house. If the homeowner sells the home for a much higher price than they bought it, they get to keep all the extra profit after repaying the bank. If the homeowner can't make the contractual interest or principal payments to the bank, the bank can ultimately sell the house and recover some of the principal it lent to the homeowner.

The process is similar for institutions that buy, sell, or provide debt for commercial real estate.

Credit vs. Equity: More Downside Protection, Less Contractual Income

It's important to note that while the equity value of a property can change over time depending on things like the demand for real estate in a particular sector or region, the overall economy, interest rates, or the particulars of the property itself, the debt principal does not change based on the property's underlying value (*Exhibit 3*). This goes back to our home mortgage example: Debt holders have more certainty and downside protection, but less upside potential compared to equity holders.

EXHIBIT 3 | Real Estate Debt and Equity in Different Market Environments



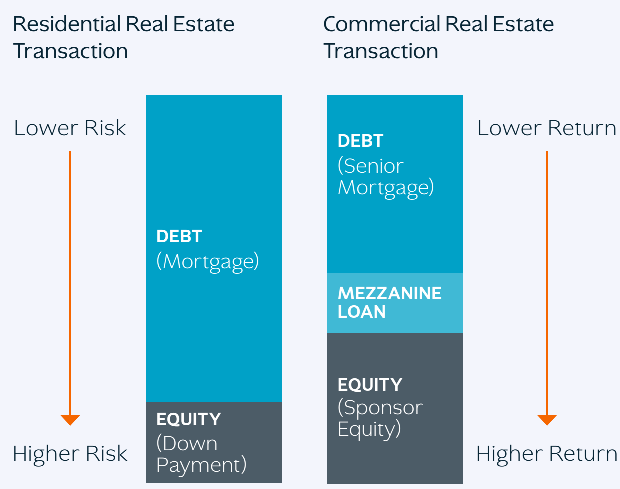
The Commercial Capital Stack

The details of the real estate equation we detailed in *Exhibit 2* can get more complex in a commercial real estate transaction. For example, a single commercial real estate transaction may involve multiple properties, multiple owners (equity holders), and/or multiple lenders. On the debt side, multiple lenders may contribute different amounts or different types of debt capital to a transaction, and each loan comes with its own terms and interest rate.

Together, these different parts of the commercial real estate equation are called a *capital stack*. *Exhibit 4* shows both a simple illustration of a typical capital stack with just one equity holder and one loan and a more complex capital stack with multiple different types of debt capital. In general, the lowest-risk capital is considered the most "senior" and is on top of the stack. The higher-risk capital is considered more "junior," with equity being the most junior piece of the capital stack, and is on the bottom.

On the following pages, we take a closer look at each of the slices in the capital stack in turn.

EXHIBIT 4 | How a Commercial Capital Stack Compares to a Home Transaction



Note: Unless indicated, the above reflects the current market views, opinions and expectations of KKR based on its historic experience and other analysis.
Historic market trends are not reliable indicators of actual future market behavior or future performance which may differ materially, and are not to be relied upon as such.

Senior Mortgage Debt

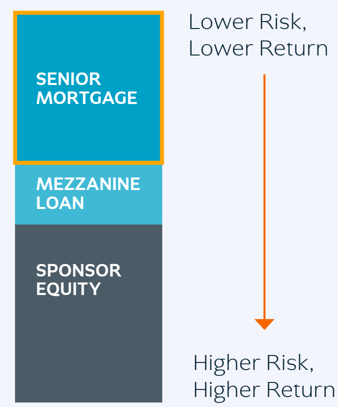
- **Lender receives principal and interest payments from the sponsor in exchange for providing debt capital.**
- **First claim on income and sales proceeds if the borrower defaults, or fails to pay interest, principal, or both.**

Senior debt, which sits at the top of the capital stack, is generally considered the least risky part of a real estate transaction. Senior debt holders are the last ones to take losses if a loan runs into trouble. They get first claim on the rental income a property produces and the proceeds of a sale.

Senior loans are secured by the property, meaning that if the borrowers can't pay principal or interest or otherwise breach the loan terms and defaults, the senior debt holders may foreclose to recoup their investment. Interest rates may be fixed or floating.

A senior mortgage loan also can be split into slices known as **tranches** through **securitization**, with the most senior pieces being the safest part of the capital stack and more junior pieces earning a higher yield or spread for taking on a higher level of risk.

Top of the Capital Stack



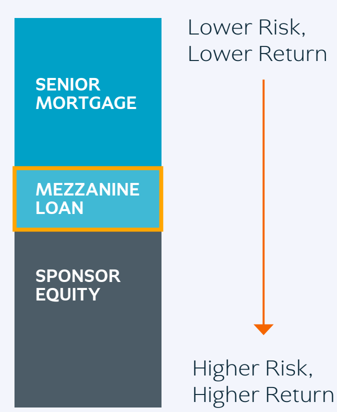
Mezzanine Debt

- **Lender receives principal and interest payments from the sponsor in exchange for providing debt capital**
- **Generally secured by a pledge of 100% of the mortgage borrower's ownership interest**
- **Junior to the senior loan, meaning it is impacted by losses before senior mortgage debt**

Senior lenders often do not want to lend beyond a certain dollar amount or a percentage of an asset's total gross value, or loan-to-value. But if a borrower still needs additional debt capital, they may consider taking an additional, separate loan to fill the gap. That loan is called mezzanine debt.

Mezzanine debt holders are next in line for payment after senior debt holders. The debt is unsecured, meaning that debt holders do not have any claim to the property itself. However, they typically have the right to take over the borrower's equity interest in the event that the borrower doesn't make the payments as agreed in the terms of the loan. Because of the higher risk, mezzanine debt typically earns higher interest rates than senior debt.

Middle of the Capital Stack



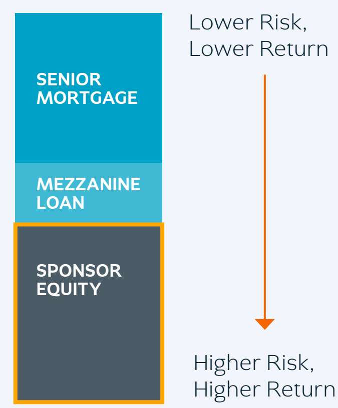
Note: Unless indicated, the above reflects the current market views, opinions and expectations of KKR based on its historic experience and other analysis. Historic market trends are not reliable indicators of actual future market behavior or future performance which may differ materially, and are not to be relied upon as such.

Sponsor Equity

- Sponsor/owner of the property
- Responsible for paying principal and interest on the loan(s)
- Sponsor receives any income generated by the property with potential upside from property appreciation
- First to absorb any losses

The most vulnerable slice of the capital stack is the equity portion, which is the money the developer or sponsor of a real estate project or transaction puts into a deal. If a property's rental income declines or a sponsor can't make payments for other reasons, these investors will lose money first. If a property appreciates, however, they have the most potential for upside.

Bottom of the Capital Stack



Word to Know - Sponsor: A person, group, or company that finds, buys, and manages a property on behalf of an investment partnership.

Note: Unless indicated, the above reflects the current market views, opinions and expectations of KKR based on its historic experience and other analysis. Historic market trends are not reliable indicators of actual future market behavior or future performance which may differ materially, and are not to be relied upon as such.

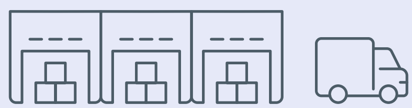
A Model Private Real Estate Lending Scenario

To illustrate how lenders participate in real estate markets, let's imagine a hypothetical scenario in which the sponsor of a transaction plans to buy an industrial warehouse and invest 40% of the value of the property in the form of common or sponsor equity. This means they need to find capital to fund the remaining 60% of the purchase. A sponsor will often turn to real estate debt for this capital. Here are two different ways lenders could provide the 60% of the capital stack that the sponsor needs *(Exhibit 5)*:

- A lender such as a bank, insurance company, or asset manager may choose to originate and hold a loan that provides capital for the entire 60% of the capital stack that the sponsor needs. This is known as making a **whole loan**, which is also a senior or first mortgage. As senior debt, the whole loan is secured by the right to take ownership and foreclose in the event of a default.
- Suppose that there is a situation where the sponsor's equity and the senior mortgage still isn't enough to acquire the warehouse. This could happen if the senior lender didn't want to fund the full amount that the sponsor needed to borrow. Perhaps the property seemed too risky, the economic environment seemed unfavorable, or the lender's balance sheet requirements prevented it. The sponsor could pursue a **mezzanine loan** to sit in between their equity and the senior mortgage. Private lenders are typically the originators of mezzanine loans.

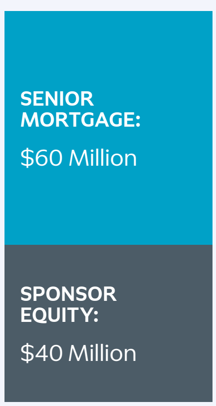
EXHIBIT 5 | Two Ways Lenders Can Finance the Purchase of a Warehouse

Industrial Warehouse Price Tag: $100 Million



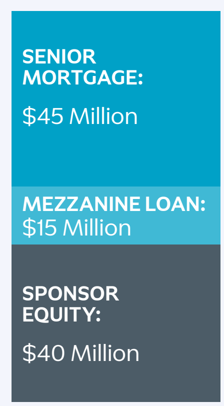
Scenario 1:

A private lender provides a senior mortgage or whole loan.



Scenario 2:

The senior mortgage lender cannot or does not want to provide the full amount of debt the sponsor needs. A mezzanine loan bridges the gap.



Word to Know - Direct Origination:

Also known as direct lending, this refers to a loan that is the result of a private, often bilateral, negotiation between a lender and a borrower.

Note: Unless indicated, the above reflects the current market views, opinions and expectations of KKR based on its historic experience and other analysis. Historic market trends are not reliable indicators of actual future market behavior or future performance which may differ materially, and are not to be relied upon as such.

Securitization: How Senior Debt Can Be Repackaged

The journey of a loan does not always end when it is originated. When a bank originates a commercial real estate loan, it may hold it on its balance sheet. However, if a bank decides that it does not want to hold all of the commercial real estate loans it has originated on its balance sheet, it can sell a loan or a group of loans into a trust. The trust will then issue bonds secured by the cash flows in the underlying loans and sell them to investors. This is called a **securitization**.

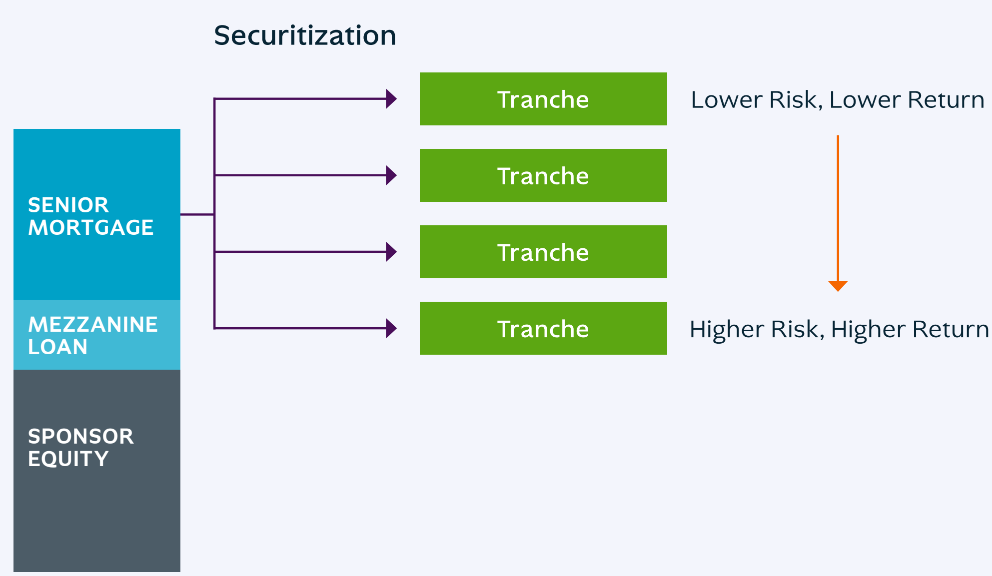
One important feature of a securitization is how a bank repackages the loans it originates. A bank divides loans into smaller pools called tranches. Investors can buy **tranches** based on yield, risk, and other factors.

Securitizations consisting of commercial real estate loans are called **Commercial Mortgage-Backed Securities, or CMBS.** When a bank sells loans for the purpose of securitization, it is essentially distributing the loan risk across the CMBS investors and freeing up its own capital in the process. There is an additional concept of risk retention for CMBS, which is designed to protect investors by requiring the issuer, often a bank or a qualified third party, to hold a portion of the securitization alongside investors for at least five years or until maturity.

Generally, CMBS tranches break down into investment-grade CMBS and sub-investment grade CMBS. The loans that carry less risk go into the higher-rated investment-grade tranches, while the riskier loans go into the lower-rated sub-investment grade tranches. The higher the rating, generally, the lower the potential return. *Exhibit 6* shows how a CMBS securitization can work.

CMBS trade publicly. While they are technically available to any investor, in practice, the instruments are so complex that most people who buy or sell CMBS directly tend to be institutional investors, like pension funds, insurance companies, money managers, or sovereign wealth funds; sophisticated fixed income investors; or asset managers.

EXHIBIT 6 | How a CMBS Is Made



Note: Unless indicated, the above reflects the current market views, opinions and expectations of KKR based on its historic experience and other analysis. Historic market trends are not reliable indicators of actual future market behavior or future performance which may differ materially, and are not to be relied upon as such.

Types of CMBS: Conduit vs. SASB

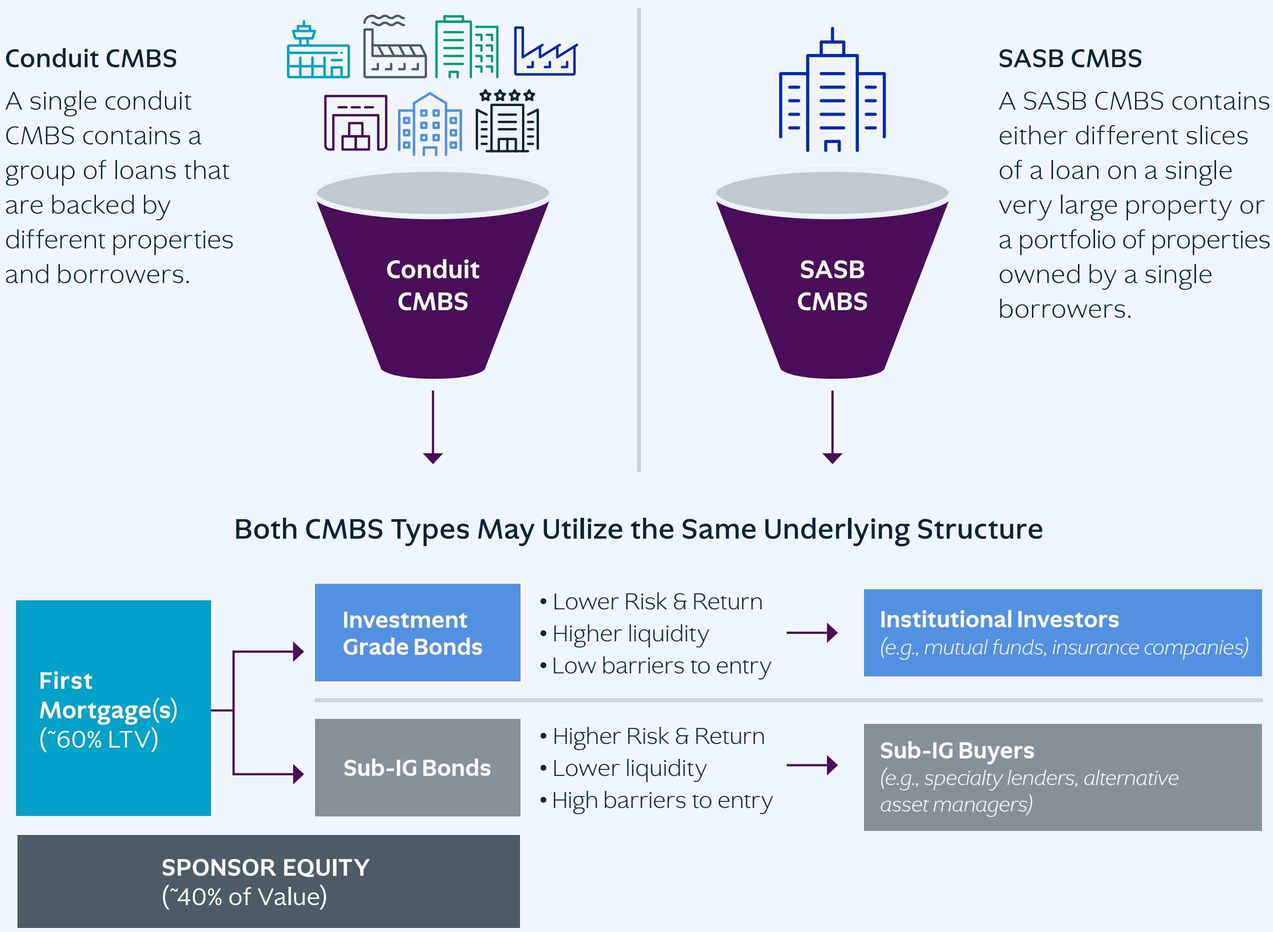
There are two main types of CMBS: Conduit CMBS and SASB CMBS. **Conduit CMBS** packages a group of loans that are backed by different properties and borrowers into a single CMBS. The idea behind conduit CMBS is that a diversified pool of loans can help to reduce the overall risk of the securitization compared to any one of the underlying loans on a standalone basis.

Single-asset, single-borrower CMBS, or **SASB CMBS**, offers a different take on the securitization of commercial real estate debt. Instead of packaging groups of loans, a SASB CMBS transaction will securitize a single loan that funds a very large property or portfolio of properties owned by the same borrower—usually over $500 million.

The underlying credit of the borrower and the quality of the loan collateral is very important in a SASB loan because repayment hinges on the health of a single asset (usually) and a single borrower. Because of that, however, only very high-quality properties with institutional sponsors are typically securitized in a SASB CMBS.

Another important difference for investors is that SASB CMBS are typically floating-rate loans with a fully extended 5-year term. Conduit CMBS usually consists of 10-year fixed rate loans.

EXHIBIT 7 | **Commercial Real Estate Securitizations: CMBS vs. SASB**



Note: Unless indicated, the above reflects the current market views, opinions and expectations of KKR based on its historic experience and other analysis. Historic market trends are not reliable indicators of actual future market behavior or future performance which may differ materially, and are not to be relied upon as such.

Conclusion

Commercial real estate credit offers a rich landscape of options for debt investors, who can consider a variety of factors when deciding on their investment strategy and allocation:

- Property types
- Geographies
- Sponsor's business plan (i.e. owning cashflowing assets, completing renovations, new development, etc.)
- Liquidity (private, untraded loan assets vs. publicly traded CMBS and CLOs)
- Risk/Return

Like other debt investors, real estate credit investors lend money with the expectation of getting it back, plus interest. That means they have to scrutinize the reputation and skill of the equity holders who will be running the property, the finances of the property itself, the long-term outlook for the sector a property is in, and other factors to determine whether the potential return justifies the risk.

Real estate credit can diversify both real estate equity holdings and other kinds of debt in investment portfolios. It offers downside protection in the form of a more senior place in the capital stack relative to common equity, and investors can further mitigate risk by lending to properties with consistent income streams and negotiated repayment terms that are favorable relative to the perceived level of risk. Real estate credit is a complex asset class, but one that we feel can be an attractive addition to many investors' portfolios.

Note: Unless indicated, the above reflects the current market views, opinions and expectations of KKR based on its historic experience and other analysis.
Historic market trends are not reliable indicators of actual future market behavior or future performance which may differ materially, and are not to be relied upon as such.

Glossary

Capital Stack: The layers of different types of equity and debt used to purchase and operate a commercial real estate investment.

Commercial Real Estate: An asset class that includes real property that is generally used for business or professional purposes rather than as a residence, including apartment buildings, industrial warehouses, office buildings, retail centers, hospitality properties, and other property types.

Commercial Real Estate Debt: The loans that help fund purchases, refinancing, and recapitalization of commercial properties. Includes both direct lending and CMBS.

Commercial Real Estate Equity: The money that a sponsor/owner puts into a transaction; value can change as the economy and individual real estate market changes.

Conduit CMBS: Bonds backed by the cash flows of a group of loans packaged together by a bank and sold to investors. Conduit CMBS trade in public markets.

Directly Originated Loan: A loan that is the result of a private, often bi-lateral, negotiation between a lender and a borrower. These loans can be senior or mezzanine debt.

First Mortgage: The original loan on a property; typically the most senior portion of the senior debt in a capital stack, with right to first repayment.

Mezzanine Debt: An unsecured loan that sits between senior debt and equity in the capital stack.

SASB CMBS: SASB stands for Single-Asset, Single Borrower. Bonds backed by the cash flows from a single large property or a portfolio of properties, typically with property values of more than $500 million. SASB CMBS are typically floating-rate loans with 5-year terms that pay off within two-to-three years.

Securitization: The process of pooling assets together and issuing interest-bearing securities based on the risk and cash flows attached to the underlying assets.

Senior Debt: The most senior portion of the capital stack, typically secured by the property itself, with lower risk and lower return than other portions of the stack.

Tranche: A slice of a securitized transaction, in this case, debt, that contains a pool of loans with similar risk or other characteristics.

Whole Loan: A loan that funds the entire debt portion of a commercial real estate transaction.

1. We assumed that U.S. commercial real estate has an average of 50% loan-to-value to estimate the size of the commercial real estate credit market. The same calculation is reflected in Exhibit 3.

Important Information

This document has been prepared solely for informational purposes. This document is not research and should not be treated as research. This document does not represent valuation judgments with respect to any financial instrument, issuer, security or sector that may be described or referenced herein and does not represent a formal or official view of KKR. This document is not intended to, and does not, relate specifically to any investment strategy or product that KKR offers. It is being provided merely to provide a framework to assist in the implementation of an investor's own analysis and an investor's own views on the topic discussed herein.

The information contained herein is only as current as of the date indicated, and may be superseded by subsequent market events or for other reasons. Charts and graphs provided herein are for illustrative purposes only. The information in this document has been developed internally and/or obtained from sources believed to be reliable; however, KKR does not guarantee the accuracy, adequacy or completeness of such information. Nothing contained herein constitutes investment, legal, tax or other advice nor is it to be relied on in making an investment or other decision. Opinions or statements regarding financial market trends are based on current market conditions and are subject to change without notice

The information in this document may contain projections or other forward-looking statements regarding future events, targets, forecasts or expectations regarding the strategies described herein, and is only current as of the date indicated. There is no assurance that such events or targets will be achieved, and may be significantly different from that shown here. The information in this document, including statements concerning financial market trends, is based on current market conditions, which will fluctuate and may be superseded by subsequent market events or for other reasons. Historic market trends are not reliable indicators of actual future market behavior or future performance of any particular investment which may differ materially, and should not be relied upon as such. This document should not be viewed as a current or past recommendation or a solicitation of an offer to buy or sell any securities or to adopt any investment strategy.

KKR

Kohlberg Kravis Roberts & Co. L.P.
30 Hudson Yards
New York, New York 10001
212-750-8300
www.kkr.com

Twitter: @KKR_Co

Linkedin: /company/kkr

Visit us on YouTube