

Back Leverage for U.S. Real Estate Debt Funds

How Back Leverage Can Enhance Control, Diversification & Potential Returns

IN A NUTSHELL

- Back leverage has become a core tool for U.S. real estate debt funds, helping improve diversification and return potential without increasing asset level risk.
 - Structural shifts, particularly banks' increasing focus on indirect lending, are improving availability and terms for back leverage.
 - Financing senior loans with back leverage (rather than originating or acquiring mezzanine loans) allows funds to maintain control, simplify capital stacks and better align with borrower preferences.
 - When used thoughtfully, back leverage is a proven, flexible tool that can support a disciplined, risk-aware investment approach.
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How Real Estate Debt Funds Seek to Generate Returns

To frame the role of back leverage, it is helpful to first understand the ways real estate debt funds can seek to generate enhanced returns. Common drivers of excess return include:

- Asset risk: Lending on lower-quality or older assets with less durable cash flows and/or elevated ongoing capex
- Location risk: Investing in secondary or tertiary markets with weaker growth and liquidity
- Business plan risk: Taking construction, redevelopment, or lease-up risk
- Counterparty risk: Investing in mezzanine loans or B-notes behind a bank or CMBS loan
- Financing risk: Using leverage to enhance returns while maintaining a more defensive asset profile

Each manager typically emphasizes different combinations of these risks depending on their strategy. Some approaches prioritize asset selection, focusing on higher-quality properties and locations, while others focus on structuring and financing decisions to shape the overall risk/return profile.

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What is Back Leverage?

Back leverage is the practice of debt funds borrowing from senior lenders (e.g. banks, insurance companies, etc.) to finance the loans they originate.

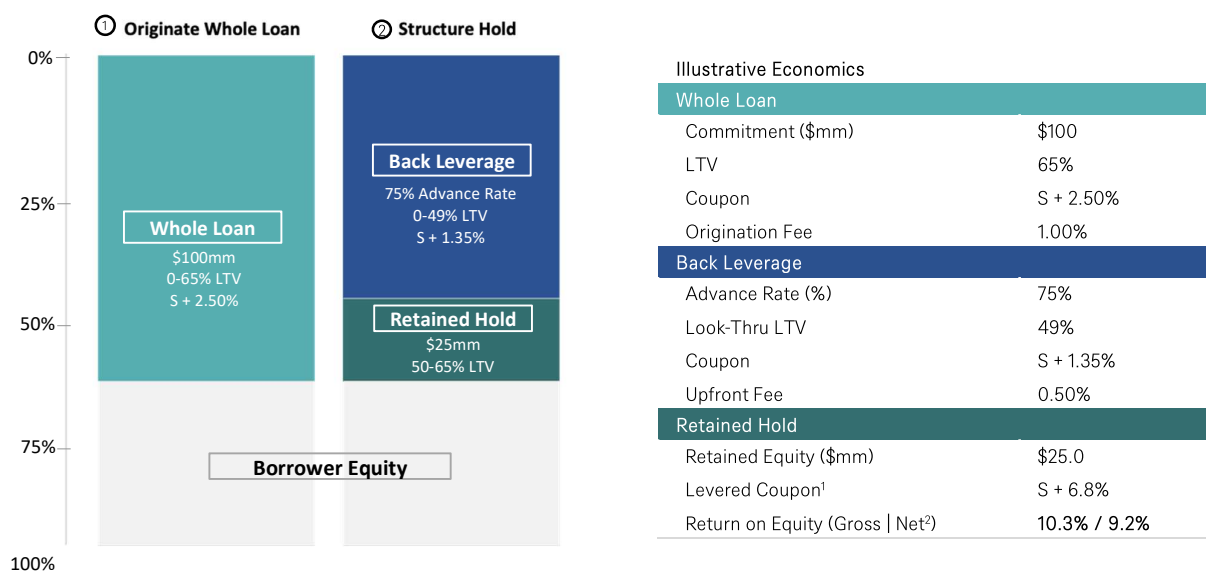
In practice:

- The debt fund originates a loan to a real estate owner (the borrower).
- A lender (typically a bank) provides financing against that loan at a specified percentage or “advance rate”.
- The spread on the back leverage is materially lower than the spread on the underlying loan.

By reducing the fund’s equity required per investment, back leverage frees up capital that can then be deployed into additional loans, increasing portfolio scale and diversification.

Please see exhibit 1 below for an illustrative example

Exhibit 1: Seeking to Structure Enhanced Returns



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Why the Market Has Shifted to Back Leverage

Historically, debt funds focused on mezzanine lending (filling the gap between senior bank loans and borrower equity) to drive returns. Over time, that opportunity set has become more limited as borrowers have increasingly preferred simpler, more streamlined capital structures.

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Today, mezzanine exposure is typically accessed in one of two ways, both of which introduce additional complexity. Investors may purchase mezzanine positions from third-party lenders acting as syndicators, which can limit control over structuring and asset-level decisions. Alternatively, managers may originate the full capital stack and then seek to place the senior loan (A-note). This introduces syndication risk which can be challenging during periods of volatility and in an environment such as today where senior lenders have reduced appetite to sit ahead of mezzanine debt.

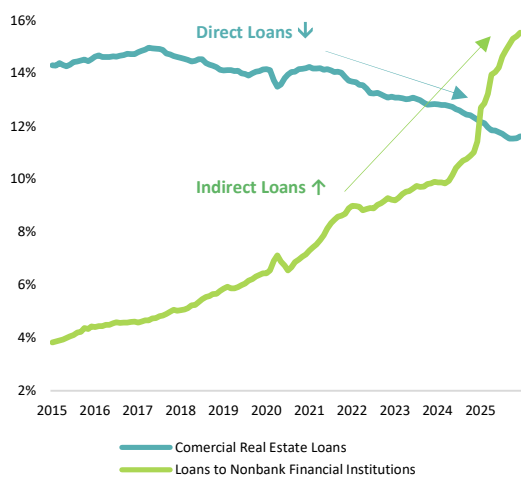
Against this backdrop, many managers have shifted toward originating whole loans and financing them with back leverage. This approach allows funds to target returns in line or above mezzanine investments while maintaining more control and accessing a broader, more scalable opportunity set.

Structural trends are reinforcing this trend. Banks are increasingly moving from direct to indirect lending, in part due to regulatory capital considerations. When banks lend directly, they face high capital charges, often 100% risk-weighting for senior mortgages. By contrast, lending to debt funds carries materially lower risk weights (~20-40%), improving return on equity even at tighter spreads.

The result is a potential win-win dynamic:

- Banks gain attractive risk-adjusted exposure with less overhead.
- Funds gain scale, flexibility, and control without sacrificing return potential.
- Investors benefit from improved economics, greater diversification, and access to a broader opportunity set.

Exhibit 2: Banks are Shifting from Direct to Indirect Lending



Loan Type	Direct	Indirect	Difference
Spread	2.5%	1.4%	-1.2%
Annualized Fee	0.3%	0.2%	-0.2%
Base Rate ¹	3.6%	3.6%	-
Coupon	6.4%	5.1%	-1.3%
(-) Cost of Funds ²	-2.1%	-2.1%	-
Net Interest Margin	4.3%	3.0%	-1.3%
Expenses ³	0.3%	0.2%	-0.1%
Expected Losses ⁴	0.4%	0.2%	-0.2%
Adjusted NIM	3.6%	2.6%	-1.0%
Loan Amount	\$50,000,000	\$50,000,000	-
x Risk Weighting ⁵	100%	30%	-70%
x CET1 ratio ⁶	11%	11%	-
Equity Requirement	\$5,500,000	\$1,650,000	-\$3,850
ROE	33%	79%	+46%

- ↑ competition among senior financing providers
- ↑ attractive borrowing terms
- ✓ Highly accretive leverage

Past performance is not indicative of future results. (1) Source: Federal Reserve. 1M SOFR as of May 2026. (2) Cost of Funds is typically 100 to 200 bps inside the Fed's Fund Rate. Assumed 150 bps. (3) Assumed 30 bps for overhead expenses for direct loan based on an industry expert's opinion. Assumed repo was discounted by 25% given no origination staff needed. (4) Expected losses are based on historic annual net charge offs that have ranged between 20 to 40 bps. Assumed 40 bps direct loan and 20 bps for the repo. (5) Risk weighting of 100% for the direct loan. Risk weightings range from 20-40% for repo. Assumed 30% for repo. (6) Common Equity Tier 1 ratio for largest banks averages around 10-12%. Assumed 11%.

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Back Leverage Structures

Debt funds primarily use two types of back leverage structures. While the mechanics can sound technical, both approaches are designed to achieve the same goal: secure financing against loans the fund has originated, while allowing the fund to retain control of both the capital stack and borrower relationship.

1. Secured Term Facility with a Master Repurchase Agreement (Whole Loan Repo)

- How it works: The fund pledges loan(s) to a financing provider as collateral and agrees to “repurchase” them at a later date at a predetermined price.
- Why it’s commonly used: Generally quick to set up and easy to scale. Once in place, new loans can be added with limited friction, making it well suited for managers with an active origination pipeline. It is also typically a cost-effective form of financing relative to more customized structures.
- Risk framework has improved meaningfully: Whole loan repos look very different from traditional securities repos. They are typically structured with longer durations (often 5 years), rather than short-term rolling exposures. In addition, credit remarking has shifted from being at the discretion of the financing provider to being tied to objective performance covenants such as debt yield and/or LTV tests, which has improved transparency and predictability.
- Control: The fund remains the lender of record and manages the borrower relationship, while the back-leverage provider sits behind the scenes.

2. Loan-on-Loan Facilities

- How it works: The fund originates loan(s) through a special purpose vehicle (SPV) and borrows against those loan(s) by pledging the SPV as collateral.
- Why it’s attractive: These facilities are typically used for single loans or smaller portfolios and are often more customized than repo structures. They can take longer to negotiate and may involve higher upfront costs, but they often provide more tailored terms. For example, some loan-on-loan facilities do not include ongoing remarking requirements.
- Control: As with whole loan repo structures, the fund remains the lender of record and manages the borrower relationship, while the back-leverage provider sits behind the scenes.

The Benefits of Back Leverage

- Scale & Diversification: By financing a portion of each loan, funds can deploy capital across more investments, which can potentially improve diversification and help support more consistent performance over time.
- Control: Funds retain full control throughout the life cycle of a loan including any potential restructuring, avoiding the complexity and potential misalignment that can arise in mezzanine or syndicated structures.
- Simpler Borrower Experience: Enables funds to offer a single, “one-stop” financing solution with cleaner execution. Borrowers avoid coordinating with multiple lenders or navigating layered capital stacks, an advantage that’s increasingly valued in uncertain financing environments.
- Strong Structural Tailwinds: Regulatory capital rules are pushing banks toward indirect lending, increasing the pool of back leverage providers and leading to more competitive pricing, terms, and structures.
- Return Enhancement: Back leverage enables funds to capture the spread between asset yields and financing costs, potentially improving portfolio returns without requiring additional asset-level or counterparty risk. See Exhibit 3 below.
- Risk Mitigation: By financing senior loans, funds can retain thicker investment positions compared to mezzanine loans, which can provide additional cushion against declines in asset value. See Exhibit 4 below for an illustrative comparison between a levered senior loan and a mezzanine loan.

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Exhibit 3: Illustrative Unlevered vs. Levered Returns

Investment <u>Without</u> Back Leverage	Investment <u>With</u> Back Leverage
Back Leverage Facility: \$100mm Coupon: 1M SOFR + 2.50% Upfront Fee: 1.00%	Back Leverage Facility: \$75mm Coupon: 1M SOFR + 1.35% Upfront Fee: 0.50%
Fund Investment Amount: \$100mm	Fund Investment Amount: \$25mm
Unlevered IRR (Gross/ Net): 6.1%/ 5.6% ¹	Unlevered IRR (Gross/ Net): 10.3%/ 9.2% ²

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Exhibit 4: Illustrative Downside Scenarios (Levered Senior vs. Mezzanine Loan)

Investment	Loan Amount	LTV	Investment	Loan Amount	LTV
Senior Loan	\$65	0-65%	Mezzanine Loan	\$10	60-70%
Back Leverage	\$49	0-49%			
Retained Hold	\$16	50-65%			

% Value Decline	Loss (\$)		Loss (%)	
	Senior Loan	Mezz Loan	Senior Loan	Mezz Loan
0%	-	-	-	-
//	//	//	//	//
30%	-	-	-	-
35%	-	(\$5)	-	50%
40%	(\$5)	(\$10)	31%	100%
45%	(\$10)	(\$10)	62%	100%
50%	(\$15)	(\$10)	92%	100%
55%	(\$16)	(\$10)	100%	100%

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Key Risks & How They're Managed

- Recourse Requirements:

At lower advance rates (<70%), back leverage can often be structured with no recourse. As leverage increases, facilities typically require the fund to provide a partial guarantee or "recourse" (generally 10-25% of the financed amount) creating potential exposure if a loan underperforms. Managers mitigate this risk by negotiating clearly defined recourse triggers, underwriting downside scenarios upfront, and sizing positions no single investment creates outsized risk.

- Margin Calls:

Modern back leverage facilities rely on objective performance tests, such as LTV and/or debt yield, rather than subjective margining, improving transparency and predictability.

Managers mitigate this risk by being selective about which investments to lever and how much leverage to apply. At DWS, we only consider back leverage for whole loan positions (not mezzanine loans) and scale leverage based on stability of the underlying asset's cash flows, allocating more to loans secured by assets with durable, predictable income and taking a more conservative approach where cash flows are stabilizing.

Leverage and liquidity must also be actively managed. We typically utilize less than the maximum leverage available and maintain liquidity sleeves within portfolios to preserve flexibility and ensure access to liquidity if needed.

- If a Loan Goes Bad:

The key is avoiding forced outcomes. Successful managers structure back leverage to preserve control, prenegotiating cure rights and grace periods following an underlying loan default to ensure sufficient runway to work through issues. This helps maintain flexibility in a downturn and supports alignment with financing partners if performance deteriorates.

Conclusion

Back leverage has become a foundational tool in modern real estate debt investing. Improved structures and strong structural tailwinds, particularly banks shifting to indirect lending, are making it more accessible and efficient. When applied thoughtfully to senior loans, back leverage can enhance returns while maintaining control and preserving downside protection.

Bottom line: back leverage can allow funds to potentially scale portfolios, simplify execution, and enhance return potential within a disciplined investment framework.

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