

Kayne Anderson

Understanding structure, return drivers, and sponsor quality in today's real estate credit market

Chase McWhorter, Institutional Real Estate, Inc.'s Managing Director, Americas, spoke in January with Kayne Anderson's **Lee Levy**, Senior Managing Director, Investments, Real Estate, about how focusing on relative value across public and private markets allows them to make the right investment decisions. Following is an excerpt of that conversation.

How should investors think about the primary drivers of return in private real estate credit today? What role do income, fees, and downside protection play in generating risk-adjusted returns?

We think about risk-adjusted returns differently than most other debt funds. We take a relative-value approach to how we deploy our investors' capital by investing in both the private and public markets. We look at new issue and secondary markets too. In the private lending market we make direct loans to our clients, and we buy loans from loan sellers as well. In the public markets we focus on SASB CMBS and agency structured products, again new issue or secondary. Simply put, we look at where bonds are trading and how the spread premium and risk profile compare to writing or buying loans ourselves. We then overlay the asset class, leverage point, and risk profile of the business plan being executed. Our goal is to provide strong risk-adjusted returns for our investors, which means we price deals and determine spread premiums on both a relative and absolute basis. Most of what we invest in is indexed to SOFR, which now stands at 175 bps less than it was before the Fed began to ease monetary policy, so it's really the credit spread where we draw the line between risk-reward. The drivers of return are straightforward. It's the base rate (SOFR), the spread, and any fees we are collecting. We do an equity-style underwriting on every investment in order to ensure we are downside-protected with a secure basis and strong loan structure.

How have loan structures and underwriting standards evolved in response to today's current market environment?

Credit spreads and underwriting standards typically move in lockstep. Since the fall of 2024, we've seen a risk-on mentality from banks and life insurance companies who mostly sat on the sidelines for the prior two years. As rates started to rise and inflation remained prevalent, traditional lenders pulled back. It was a great time to be a non-bank lender. It's been a more competitive lending environment because banks and life insurance companies have come back as direct lenders which has helped drive credit spreads to fairly tight levels. Banks have also stepped up their balance sheet allocation for back-leverage lending to alternative lenders. While loan origination volumes are up, there are also more capital-chasing deals. The hardest thing to navigate has been loan proceeds being pushed higher at tighter credit spreads. In terms of underwriting, we are of course focused on the debt yield and loan-to-value at closing, but we spend most of our time thinking about how those metrics look once the business plan has been

fully executed. We're leaning in on deals where we like our going-in basis, in asset classes and submarkets where we expect to see outperformance. Loan structures and underwriting standards have certainly become more sponsor-friendly, which has made it a more challenging investment environment for us. For the right deals, we are leaning in.

What types of real estate debt products are most popular today particularly from an income and risk-management perspective?

Let's first answer your question from the perspective of an institutional LP investor who wants exposure to the commercial real estate sector. For the past couple of years floating-rate-based real estate credit investments have been great for investors who select the right manager. When SOFR was elevated in the mid-fives and credit spreads were around 100 bps wider compared to today, an income debt fund could generate attractive current yields of 9 percent to 11 percent. As the base rate has gone down, it's gotten harder to deliver such outsized returns, but there is still a healthy cash-on-cash yield premium for an income debt fund. Again, our ability to toggle between public securities and private lending allows us to find the best risk-reward. When there's capital market dislocation, we can lean into the public securities market. When credit spreads widen, they tend to happen instantly in the public markets; repricing in the private markets tends to take longer, which requires a sustained capital markets dislocation or a fundamental shift in risk appetite.

From the perspective of a debt investor, the back-leverage market has become incredibly competitive and creative in terms of the types of structures being offered. We see the benefit of this when we borrow money from banks to finance our investments. Back-leverage providers have been meeting the market as credit spreads on whole loans have tightened. Additionally the CLO market has provided many debt fund managers with liquidity for back leverage. So even though whole loans spread has been compressing, the back-leverage pricing and structure have grown more favorable. So, net-net, we can deliver very similar returns to our investors despite credit spread tightening and lower base rates.

How should investors compare real estate credit yields and risk characteristics to other private credit or fixed-income strategies? And then what differentiates real estate-backed lending?

We make loans that are senior-secured by hard assets, and we maintain control. We're making bilateral deals, while private corporate credit tends to be broadly syndicated and not secured by hard assets. A lot of fund managers, especially in the leverage finance and high-yield sectors, are buying private credit from banks that are packaging them up and syndicating them. Since we're dealing directly with the sponsor on a case-by-case

basis, we create the structure and pricing we consider to be commensurate with the risk of that asset. We're not buying a syndicated loan sale process where the structure and economics are baked. Our investment decisions are driven by our ability to unearth attractive opportunities that are senior-secured and deliver strong risk-adjusted returns.

How has sponsor behavior changed over the past 12 to 24 months? What trends are you seeing around leverage, equity, contributions, and refinancing?

Sponsors are much more realistic about the state of the interest rate market and the valuation of their assets, having come to the realization that 2021-2022 values are behind us, and interest rates aren't going to save the day. Many sponsors can't sell at the prices they want, so they're looking to the lending community to buy more time. We're seeing bridge loans being refinanced with new bridge loans rather than with sales or more permanent debt. This is coming both from sponsors and lenders who have been sitting on assets that have not hit their business plan and/or were purchased at a basis that limits their ability to monetize those assets today. We are seeing situations where banks have already modified loans and given extensions. At this point, if there is no immediate repayment on the horizon, they need to move on and sell the loans.

LP equity for development deals continues to be a hard place for sponsors to find liquidity. On development deals, sponsors are looking to use higher leverage from lenders to help shrink the size of equity checks. In some deals, we are seeing the GP bring 100 percent of the equity capital. Another recent development is that GPs are looking for feedback from lenders early in the process in order to figure out what amount of debt they can borrow and at what price. This helps developers solve for how much equity they need and allows them to approach a broader group of LP equity investors. It's completely backwards from how development deals used to be, when the equity would be fully raised before the developers went to the lending community for construction loans.

What defines a high-quality real estate sponsor in today's environment, and how do you evaluate alignment between lender and sponsor?

A high-quality real estate sponsor is someone with a proven track record in owning, operating and developing assets. They have enough liquidity to execute on a business plan, and in the case of a development deal, they have the balance sheet to stand behind completion and interest and carry guaranties. We look at reputation, the balance sheet, and the ability to execute. The amount of cash equity in the transaction is always helpful, but the best alignment of interest happens when we think the future value of the real estate will create a compelling return on the equity invested by the sponsor. We structure our loans to maintain alignment of interest over the course of the deal with milestones and covenants, like pre-leasing or lease-up thresholds that let us check in along the way. If the business plan starts to veer off

course, those mechanisms allow us to come back to the table and re-establish that alignment of interest if need be. Real estate is a relationship-driven business. There must be mutual trust and respect between counterparties. If the business plan isn't working out, if it's not the deal we underwrote, then as a lender, we need the ability to help course-correct and get the deal moving back in the right direction.

When markets are or become stressed, how do you weigh sponsor quality versus asset quality in underwriting and structuring decisions?

Regardless of the state of the market, we always look at the real estate first. Don't get me wrong, sponsorship is incredibly important, but we are making non-recourse loans. We start with a real estate valuation, underwriting the market and the asset. Then we look at the sponsor. Sponsorship quality becomes even more important when we're looking at development deals or loans that are already experiencing distress. We do look at buying nonperforming and subperforming loans; in those situations, the loan documents are especially crucial. The sponsor, the loan structure, the proceeds and the pricing are important, but for us it all starts with the real estate and our knowledge of the sector. On the topic of sector selection, Kayne Anderson focuses on multifamily, student housing, senior housing, medical office, industrial and self-storage. These are the same asset classes that our equity team invests in. Choosing the asset classes we invest in is purposeful. Our strategy, sector experience and relative-value lens across private and public markets allow us to be wherever the best risk-reward is.

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COMPANY OVERVIEW

With approximately \$20 billion of assets under management, **Kayne Anderson Real Estate's** investment objectives are to create strong risk-adjusted returns by focusing on current cash yield and increasing value through cash-flow growth, while remaining sensitive to capital preservation. Since 2007, Kayne Anderson Real Estate has invested in alternative real estate sectors, including medical office, high-end senior housing, off-campus student housing/multifamily, self-storage, and light industrial. Our vertically integrated team brings expertise in all aspects of real estate investing and management to each of our investments, thereby maximizing operating capabilities.

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