The Leverage Paradox

How non-recourse debt has the potential to reduce risk in institutional real estate portfolios

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When the real estate cycle turns, years of hard-won gains can go up in smoke in a matter of months unless portfolios are built to withstand the market's proverbial wildfires. Lessons from managing vulnerabilities in nature may offer investors a counterintuitive way of approaching leverage, not simply as a source of risk, but as a potential tool for resilience.

- **In institutional real estate investing, leverage has long been seen as a risk amplifier, however, with the right strategy, leverage can be a mechanism of defence against the worst effects of a severe downturn.**
- **The real risk question is not whether leverage is used, but how it is deployed. Reinvesting leverage proceeds into opportunities where the risk is lower than the leverage itself, can create a 'firebreak' against extreme losses.**
- **The portfolio must be managed as an integrated balance sheet, with the real estate assets, borrowings, and loan investments considered jointly rather than in isolation.**

Severe market dislocations are the financial equivalents of a natural disaster: unpredictable, seemingly uncontrollable and, over a long enough time horizon, inevitable.

In managing nature's risks, the most effective strategies often look counterintuitive at first glance. In forestry, a firebreak is a strip of vegetation deliberately cleared to stop the spread of wildfire. A portion of the forest is sacrificed to protect the integrity of the system as a whole. In flood management, specific areas are intentionally allowed to inundate, absorbing excess water to protect more valuable land, infrastructure and real estate elsewhere. Across these domains, resilience does not come from resisting every force uniformly but by redirecting the risk, creating controlled zones where pressure is absorbed before it can spread.

Figure 1: A firebreak can redirect risk

In institutional real estate investing, leverage has long been seen as a risk amplifier. This assumption, although not entirely wrong, is at best a dangerous oversimplification. Under the right conditions and using the right strategy, leverage can be a mechanism of defence, stabilising investment outcomes and creating a buffer against the worst effects of a severe downturn. This article explores how leverage, when properly deployed, can function, not as fuel for a fire as the received wisdom suggests, but as a firebreak against extreme loss.

The problem with core real estate

Data shows that over the long term, real estate benefits from a rising market more often than it suffers in a falling one. Yet extreme dislocations, often triggered by external shocks, can occur as unexpectedly as a fire or a flood, driving down the long-term performance of institutional real estate portfolios. Owing to its illiquidity, property can be especially vulnerable to periods of severe market dislocation, leading some pension funds and insurance companies to question the asset class's place in their permanent allocations.

Defensively minded investors have traditionally responded to this challenge by concentrating their portfolios on core assets (i.e. high-quality, well-located properties) held without leverage.

The logic is straightforward: by owning the best assets and avoiding debt, investors reduce the risk of permanent capital loss and eliminate the possibility that leverage will amplify losses in percentage terms.

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As intuitive as this approach may seem, the drawback is that performance of such strategies has repeatedly disappointed. Historically, according to the MSCI UK Annual Property Index, core un-levered assets despite their apparent conservatism, have proven far more vulnerable to market downturns than their role in investment portfolios implies.[1] They avoid the amplification of leverage, but they do absorb the full force of every valuation decline.

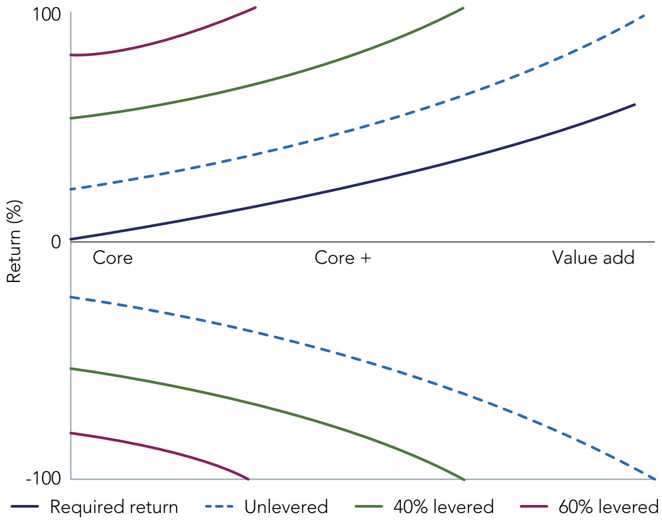
While this performance vulnerability is widely accepted as the cost of preserving upside potential, we believe the industry has, over time, turned a habit into a principle, thus painting all leverage with the same brush. Instead, we view leverage as a tool. A blunt tool can be dangerous but as a sharp tool used with skill, within a coherent portfolio capital structure, and combined with genuinely defensive reinvestment of the proceeds, leverage can provide real downside protection in certain scenarios where protection is most needed.

Rehabilitating leverage: From relative returns to absolute outcomes

In public markets, risk is typically defined as the volatility of returns. In private markets, it is better understood as the range of things that can happen, most of which will not. Leverage widens this range, and the higher the leverage, the greater the potential gains and losses. Measured as a percentage of invested equity, a leveraged position will always exhibit greater downside than an equivalent unlevered one. This is the foundation of the conventional wisdom, and as far as it goes, it is correct at the asset level.

[1] MSCI UK Annual Property Index.

Figure 2: The traditional investment paradigm
Internal rate of return

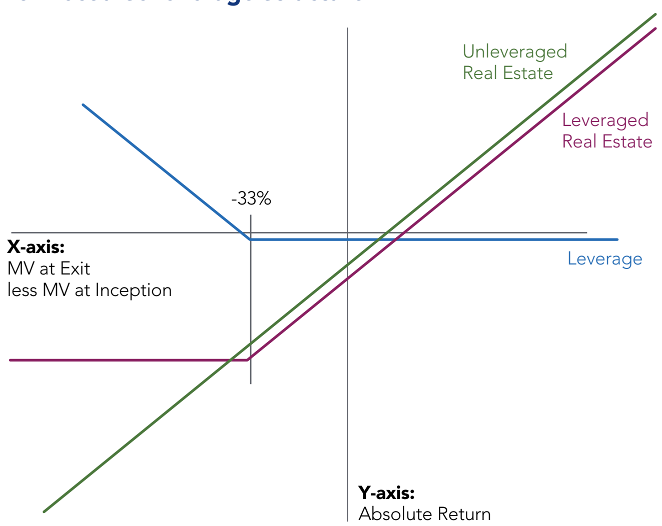


Source: Federated Hermes

A critical, and often overlooked, limitation of this analysis is that it measures returns solely as a percentage of paid-in capital. It does not capture what institutional investors must also care about: the actual amount of money they get back – the euros and cents, the pounds and pence. Focusing only on percentage losses is akin to judging a wildfire by the proportion of a single patch of woodland burned (i.e. the forest stand) rather than by the value of what was lost across the entire forest.

Consider an asset purchased for €100m using €33m of equity and €67m of non-recourse debt (a day-one loan-to-value ratio of 67%). Now consider the same asset purchased outright for €100m with no debt at all. If the asset appreciates, the comparison is broadly similar in absolute terms. The equity investor in both the levered and unlevered deals capture the upside.

Figure 3: Risk of loss
Illustrative downside protection potential from non-recourse leverage structure



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Now suppose the value of the same asset declines by 50%. The unlevered investor absorbs a €50m loss. For the levered investor – when the value of the property falls below the outstanding loan balance – the lender takes possession of the asset under the non-recourse structure. The borrower walks away, having lost their €33m equity investment, but nothing more. The bank absorbs the remaining loss. Therefore, in a scenario of severe market stress, the levered structure has produced a €17m better outcome in hard cash.

This is no accident. Non-recourse leverage embeds a structural put option; a contractual floor beneath which the investor's losses are capped. If the value of the underlying asset falls sufficiently, the investor can walk away by surrendering the asset to the lender, with no further claim on the investor's capital. In effect, the lender has written insurance against extreme downside outcomes; the outcomes that we see in end-of-cycle downturns. In exchange for the stream of interest payments received over the life of the loan, the lender assumes a portion of the tail risk associated with severe declines in asset value.

> **While leverage undoubtedly amplifies gains and losses across a normal range of outcomes, its effect is different in extreme scenarios**

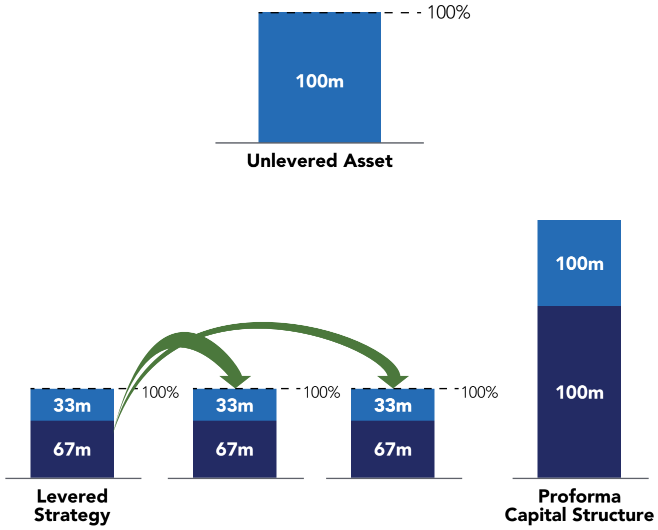
Viewed through this lens, non-recourse leverage is more than simply a source of borrowed capital. It is also a mechanism for transferring catastrophic downside risk from the equity investor to the lender. While leverage undoubtedly amplifies gains and losses across a normal range of outcomes, its effect is different in extreme scenarios. Once asset values fall below a certain threshold, the investor's exposure no longer increases in line with further declines. The downside has effectively been capped.

The missing variable: how leverage proceeds are deployed

We appear to have arrived at a paradox: leverage seems both to increase risk (in percentage terms) and to reduce it (in absolute terms). Resolving this apparent contradiction requires looking beyond leverage at the individual asset and considering how the proceeds are deployed within the broader portfolio. In other words, the key question is not whether leverage is used, but what is done with the capital it releases. Like a firebreak, its effectiveness depends on the surrounding landscape. The real estate assets, borrowings, and reinvested capital must therefore be managed as an integrated balance sheet, rather than as separate components viewed in isolation.

Consider our hypothetical €100m investment mandate. In one scenario, the entire sum is invested in unlevered core assets. In another scenario, the same €100m is deployed across a portfolio of assets at 67% loan to value (LTV), with each €33m of equity supporting €100m of real estate, giving total gross asset value of €300m. This is the leveraged portfolio that most people imagine when they worry about leverage risk. A 40% fall in valuations across the assets would wipe out the entire €100m of equity. The unlevered portfolio would suffer a €40m loss. The fully levered portfolio suffers an unsurvivable total loss.

Figure 4: A hypothetical €100m investment mandate



Source: Federated Hermes

But that is not the only way to use leverage. What if, instead of reinvesting the borrowed funds into additional levered deals, you invested them into something genuinely defensive?

Imagine that the borrowing proceeds are held as cash. You own €33m of first-loss equity in a levered real estate asset, and you hold €67 million in cash. If the asset value falls by 40%, you hand the keys back to the bank. Your loss is capped at €33m. You still have €67m in cash.

Your total portfolio value is €67m. That is an 11% better outcome than the unlevered investor who has absorbed a full €40m loss on their €100m portfolio (for the sake of simplicity we are considering only capital value). Of course, large valuation declines are possible and the protection the cash balance offers in that case is larger.

While this isn't a practical investment strategy given the low yield on cash, it illustrates the benefit of reinvesting the leverage proceeds into something that is lower risk than the leverage itself. Losses are first absorbed by a defined equity tranche, while the redeployed capital sits in a senior position whose risk is lower than that of the original borrowing.

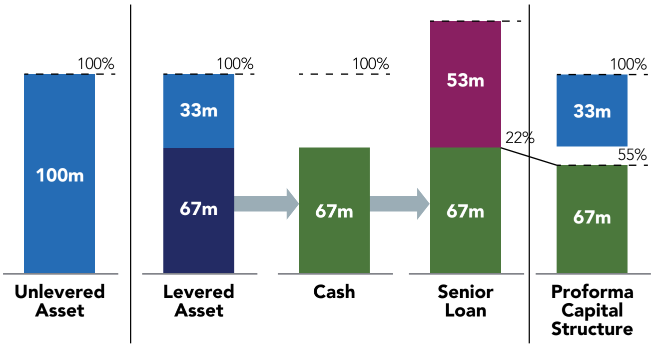
Building the break: leverage as a line of defence

Just as a firebreak in a forest prevents the flames from spreading beyond a certain point, the combination of non-recourse borrowing and a safer reinvestment creates a gap in the portfolio where further deterioration in the market does not automatically create further losses in the portfolio.

For example, reinvesting the proceeds in a senior real estate loan at a lower risk (for example, a lower LTV), the pro-forma portfolio capital structure contains a band where, in a severe downturn, the investor has notionally no exposure. The equity in the real estate deal may be lost, but if the senior loan investment avoids that loss, the firebreak will effectively stop the flames from spreading.

Applied to the previous example, the 67% LTV borrowing proceeds are reinvested into a 55% LTV senior loan on a different property. The investor now has a first-ranking loan position up to 55% of that asset's value, a first-loss equity position at 33% of the levered asset, and a gap in between (the firebreak) where, if markets deteriorate to that degree, there is no exposure. The total investment is still €100m, but the loss – in a 40% value decline – is now €33m (33% of the total investment) rather than €40m. This is better in both percentage terms and in absolute cash terms.

Figure 5: A improved model



Source: Federated Hermes

The inefficiency behind the firebreak

The most obvious objection to this structure is pricing. If senior real estate loans are lower risk than the leverage taken on the real estate equity, how can they possibly yield enough to offset the cost of borrowing? In efficient markets, they could not. But real estate debt markets, particularly in the mid-market, are not price efficient. A borrower completing a time-sensitive acquisition will gladly pay for execution certainty. This market dynamic creates persistent opportunities to earn returns in senior debt that capture more than just the risk being assumed. This makes the arithmetic of this portfolio structure viable.

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It is also worth noting that senior real estate debt has, over the past decade, outperformed core unlevered real estate in total return terms.[2] This reflects a structural mispricing of real estate credit relative to direct property exposure that has persisted for years.

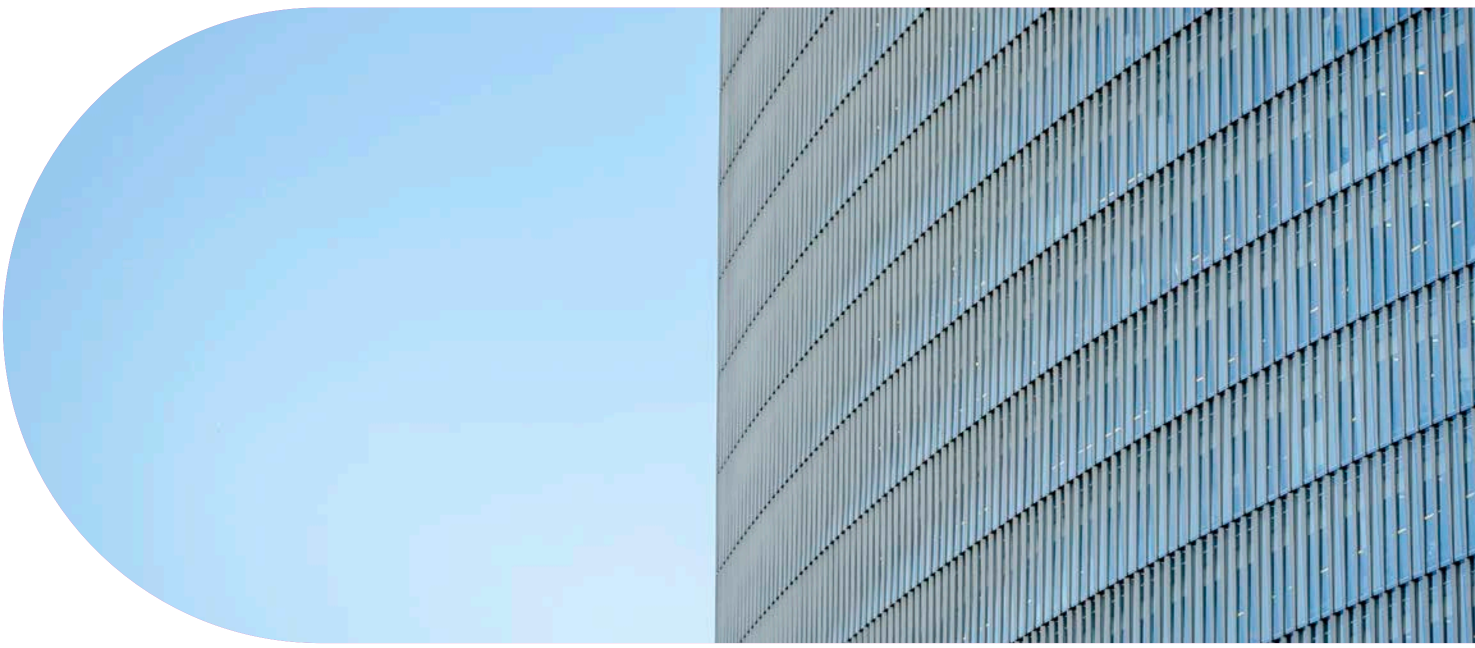
Conclusion: A 'whole portfolio' approach

The assumption that leverage adds risk was never a law of nature; it is a useful shorthand that is generally valid at the individual asset level. Viewed through the lens of an integrated portfolio, however, the picture is more nuanced. When embedded within a disciplined capital structure, non-recourse leverage can reduce risk during periods when extreme market events threaten to overwhelm skill entirely.

> **The objective is not to eliminate losses – just as a firebreak cannot prevent a wildfire, nor a flood barrier every inundation – but to contain them**

For this approach to work, the portfolio must be managed as an integrated balance sheet, with the real estate assets, borrowings, and loan investments considered jointly rather than in isolation. The objective is not to eliminate losses – just as a firebreak cannot prevent a wildfire, nor a flood barrier every inundation – but to contain them. By using leverage to create a structural boundary beyond which losses cannot easily spread, the portfolio becomes more resilient to the severe market dislocations that can overwhelm even the best strategies.

[2] Source: MSCI Burgiss Private Capital Index / MSCI Real Estate Debt Fund Index



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