



Is Your Private Credit Fund Truly “Credit”

Overview

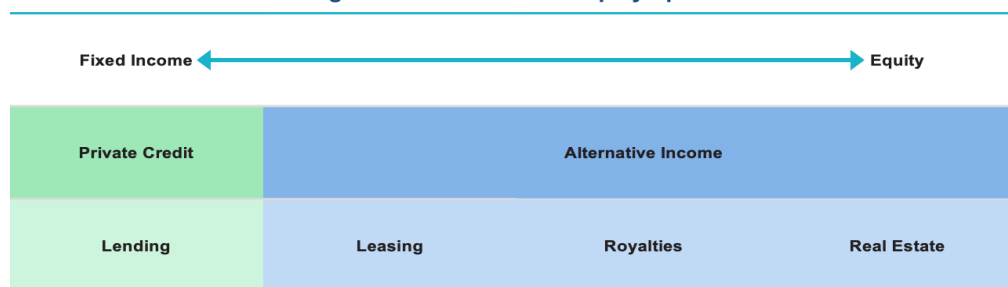
The term “private credit” is sometimes used loosely to include income generating investments that have equity-like characteristics and are not strictly “credit”. As allocators seek to diversify their private credit exposure, it’s critical to understand that these two sources of income are two different animals with distinct risk-return characteristics.

Private credit is an asset class that is becoming an integral part of investor portfolios. It is often perceived as synonymous with its largest segment: corporate direct lending. Yet, as many as 30 additional private credit segments exist. Asset-based lending, real estate debt and specialty finance are some of the better-known segments under this umbrella.¹

We have observed that a number of popular funds with significant allocations to private credit extend their investable universe beyond the strict definition of “private credit” and may include non-lending sources of income like leasing, royalties, and real estate equity.

Distinguishing between these two groups of income-generating strategies may seem pedantic, though we believe it is quite important. Why? Because private credit is a fixed income investment, while non-lending sources of income have equity-like characteristics. Since they have materially different risk-return characteristics, allocators need to be mindful of what exactly they own as they seek to diversify their private credit portfolio.

Sources of Income
Along the Fixed Income vs. Equity Spectrum



¹ We have written about a framework for diversifying across the various types of private credit in our recent white paper “[Optimize Your Private Credit Exposure.](#)”

Private Credit Defined

Private credit is defined as lending to businesses and individuals outside of the banking system and public markets. The key word in this definition is “lending.” The borrower owes the lender contractual payments until the principal is repaid at maturity, and the lender has pre-determined remedies should the borrower cease to make those payments.

From a capital structure perspective, the private credit lender is senior to the borrower. This provides a cushion for the lender should the underlying company or assets come under distress.

Non-Lending Sources of Income Defined

We define non-lending sources of as a private investment in an asset or entity that produces yield in a structure outside of lending. Unlike private credit where an investor lends against an asset like a company or a real estate project, in alternative income, the investor buys the asset itself.

These private investments are akin to high-dividend stocks in the public markets that have a high yield at the time of purchase, in that over time both the yield and asset value will fluctuate based on the economics of the underlying asset.

Examples of Alternative Income Strategies

Leasing

The lessor buys an asset and leases it to the lessee at a defined rate over an agreed-upon period. Examples include construction equipment, rail cars, or aircraft. The lessor owns the property and at the end of the lease period is responsible for redeploying the asset—whether by renewing the lease, leasing to another party, or outright sale.

There is no “principal” to be repaid, and the lessor assumes the risk of how much the asset may be worth at the end of the lease. Leases are also generally easier to break compared to debt, and breakage may occur when the asset value has decreased.

Royalties

An investor buys an asset and receives royalty payments from counterparties for the right to use the property. Payments are typically calculated as a percentage of revenue generated from its use. Examples include drug patents, music royalties, and mineral rights.

Royalty payments fluctuate based on supply/demand forces that drive how much, and at what fee rate, the underlying asset is used. The value of the royalty asset varies largely in tandem with the underlying cash flows and is further exposed to the risk of becoming obsolete or

depleted. The long-term nature of royalties also makes them particularly sensitive to changes in interest rates.

Real Estate Equity

An investor buys a property and receives rental income from commercial or residential tenants.

The economics of real estate ownership are similar to royalties in that the payments and value of the asset are determined by occupancy rates and rental rates. However, real estate investments typically employ significant leverage to achieve targeted returns, which amplifies risks.

Implications for Asset Allocators

We want to be clear that private credit and non-lending income investments are valid sources of potential income. However, they are different animals. Being mindful of this distinction can help allocators make more thoughtful portfolio decisions, such as:

- Recognizing that the risk-return characteristics of funds that allocate to both private credit and non-lending income sources will be different than those of dedicated private credit funds,
- Deciding whether to make a “bundled” investment across both asset types or make unbundled allocations to dedicated funds such as private real estate equity or royalties, and
- Determining from which “bucket” to fund potential investments in these strategies.

Disclosures

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