FFCM

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Taxes, Inflation, and Private Credit

"Things are not always as they seem; the first appearance deceives many."
-Phaedrus

Investors have a new love interest, and her name is Private Credit. It's easy to see the appeal. She's exciting, offering higher yields than the traditional fixed income investments. She's reliable, promising a safe, dependable return (a refreshing change from the volatile equity markets). Perhaps most of all, she's understandable, with regular interest payments contracted over a defined term. What's not to love?

This memo is intended for individual investors who are considering making a private loan or adding a private credit position to their portfolios. While private credit has many attractive qualities, it's important to be aware of some of the drawbacks and risks that may not be immediately apparent. In our experience, many individual investors implement more obvious risk mitigation strategies (maintaining a low loan-to-value (LTV) ratio, ensuring sufficient collateral, personal guarantees, etc.). However, we find that they often underestimate the impact of taxes and inflation on their actual returns. Additionally, should a loan default, most individual investors don't have the team or contacts in place to manage the non-performing loan. As a result, we think many investors are not aware that they may not be adequately compensated for the risk they bear.

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Private Lending: The Fundamentals

Private lending (or private credit) is essentially when an individual or a group of investors loan money directly to a borrower, rather than the borrower going through a traditional bank or financial institution. It's a straightforward process: the lender provides the borrower with funds, usually secured by some form of **collateral** like real estate, the borrower agrees to repay the loan at an agreed upon **interest rate** usually with monthly payments until the **maturity date** when the outstanding balance will be paid in full. Often the borrower will give additional security to the loan with additional **recourse** like a personal guarantee wherein the borrower can be held personally responsible if the underlying collateral doesn't perform.

The loan generally closes upon the execution of a few key legal documents. The terms of the loan—including the interest rate, maturity date, repayment schedule, and collateral—are typically outlined in a formal loan agreement. For real estate, the collateral is secured with a deed of trust. Personal guarantees and their terms are usually detailed in separate guarantees.

Lenders earn **revenue** from private loans primarily through interest income, with regular payments based on the agreed-upon rate. They often supplement this income in a variety of ways. They often charge an origination fee at the start of the loan, prepayment penalties if the borrower repays early, late fees for missed payments, and extension fees if the borrower needs more time to pay off the outstanding principal.

Lenders incur several expected expenses when originating and servicing a private loan. These include upfront costs like legal fees for drafting documents, due diligence costs such as credit checks and appraisals, and servicing fees if a third party manages payments and communications. Often, upfront costs can be partially recouped by passing them on to the borrower. Lenders may also face various administrative expenses, such as collection efforts and taxes. For small lenders with performing loans, these are generally minimal and are more likely to involve time and effort rather than significant financial outlay.

The Impact of Taxes and Inflation

While private loans can offer attractive interest rates, it's important for private lenders to understand that the **after-tax real return on private loans may be *far* lower than the stated interest rate**. Taxes *materially* reduce a loan's effective return and inflation (sometimes significantly) diminishes the purchasing power of outstanding principal. Investors who primarily have experience with *tax advantaged* and *inflation protected* forms of investing (e.g., real estate equity investors) often overlook these two immense headwinds.

Interest income is generally taxed as ordinary income, making it subject to the same federal and state tax rates as wages and salaries. The amount of tax owed varies based on the taxpayer's overall income and tax bracket but for high-income earners (most accredited

investors), this results in a 37% federal tax on interest income earned. In addition, investors in high-tax states like California and New York may face state income taxes of up to 10%. Combined, these taxes can consume nearly half of the gross return generated from a private loan, in effect halving the actual yield.

Inflation further erodes the real value of both interest income and the outstanding principal. Even if a loan offers a high interest rate, rising prices diminish the purchasing power of both the income earned and the principal repaid. For example, an 11% loan in a 3% inflationary environment yields a real pre-tax return of 8% (a reduction of over 25%). In contrast, equity investors often place less emphasis on inflation, as some real assets and certain companies can increase in value with rising prices, helping to protect returns.[1].

Working in tandem, taxes and inflation can significantly erode the actual return of a loan. For example, consider an 11% loan. Assuming the lender is in a high-income tax bracket and pays 40% in income taxes, the after-tax return drops to 6.6%. Assume 3% inflation, and the after-tax, real return drops to just 3.6% — a drastic reduction from the original 11%.

A 3.6% real after-tax return is modest but positive. Unlike an equity investment, however, this 3.6% return represents the best-case scenario. A loan can never outperform its promised yield and, as such, any surprises can only be negative.[2] Defaults, delays, or unexpected expenses will only serve to reduce this already low return. Considering the illiquidity and potential challenges of private loans, investors must ask: is this limited return worth the significant risk and effort involved? At times it may be, but low returns require prudent investors to take an inordinate amount of caution.

Interest Rate on Loan	**After-tax Real Return (40% Tax, 3% Inflation)**
11.0%	3.6%
12.0%	4.2%
13.0%	4.8%
14.0%	5.4%
15.0%	6.0%

[1] This is not always the case. High inflation can squeeze profit margins and reduce consumer spending, negatively impacting equity values. It can have second order effects like an increase in interest rates. Inflation is complex and its effects are often impossible to predict even by the world's most prestigious economists.

[2] There are situations where this is not the case. Distressed debt investors buy loans below par value and can profit if the borrower recovers, or the collateral value exceeds expectations. This can result in a higher-than-expected return/IRR.

Evaluating Private Debt vs. Real Estate Investments

Many of our firm's investors are familiar with private real estate investments but have limited experience with private debt. They often compare the interest rate of a loan to the cap rate on a real estate investment. This is not an apples-to-apples comparison as factors like inflation and tax treatment act as tailwinds for real estate investments but as headwinds for debt.

	Private Loan	**Real Estate**
Grows with Inflation	No	Expected
Potential to Outperform Inflation	No	Yes
Taxed As	Ordinary Income	Passive Income Capital Gains
Can Generate Taxable Losses	No – Unless Actual Loss Occurs	Yes

The following exhibit illustrates the impact of inflation, growth, and varying tax rates on a private loan investment versus a five-year Core+ housing investment, which is expected to grow with inflation. The private loan has an 11% interest rate, while the real estate investment has a 5.5% CAP rate. Despite the CAP rate being half the interest rate, the exhibit makes the case that the real estate investment may *outperform* the private loan once tax and inflation are considered.

The exhibit does not offer a perfect comparison between the two investments. The debt certainly has positive characteristics not accounted for by the numbers. For example, the private loan is shorter-term, while the real estate investment is long-term. Additionally, debt generally carries less risk than equity, as equity tends to be more volatile. However, the comparison also overlooks potential bad debt expense on the loan side, which could significantly impact returns. Further, the real estate investor may be able to utilize the full taxable loss provided by depreciation, to offset other passive income which can materially improve their returns.

In conclusion, the exhibit does not indicate that one investment is superior to the other. Instead, it highlights the complexity of comparing two distinct investment types. Factors like risk, duration, tax benefits, and potential losses must be considered beyond just the CAP rate or interest rate. Comparing a loan's interest rate to a real estate investment's CAP rate alone is not enough to make an informed investment decision.

Exhibit A – Private Loan vs Real Estate Investment

Private Loan

Item	Rate		Amount
Investment Size		$	100,000
Interest Rate			11.00%
Gross Profit			11,000
Depreciation			-
Pre-tax Profit			11,000
Income Tax Expense (Credit)	40%		4,400
Net Income		$	6,600
Cash Flow			
Net Income			6,600
Plus Depreciation			-
Free Cash Flow		**$**	**6,600**
Cash-on-cash (CoC) Return			*6.60%*
Inflation Adjusted Return			
Free Cash Flow		$	6,600
Less Change in Purchasing Power	3.0%		(3,000)
Inflation Adjusted Cash Flow			3,600
CoC Return (Inflation Adjusted)			*3.60%*
Unrealized Gain			
Inflation			-
Outperformance above Inflation			-
Total Unrecognized Capital Gain			-
Unrealized Gain			0.00%
Future Taxes			
NPV of Capital Gain and Depreciation Recapture			
Return Drag from Future Taxes (NPV)			

Return Summary	
Cash Return (Pre-tax)	11.00%
Cash Return (Adjusted for Tax Expense/Credit)	6.60%
Cash Return (Adjusted for Tax and Inflation)	3.60%
Unrealized Gain (Non-Cash)	0.00%
Return Drag from Future Taxes (NPV)	0.00%
Total Return (Taxed)	6.60%
Total Return (After Tax & Inflation)	3.60%

Private Real Estate Investment

Item	Rate		Amount
Investment Size		$	100,000
CAP Rate			5.50%
Gross Profit			5,500
Depreciation Expense			13,000
Pre-tax Profit			(7,500)
Income Tax Expense (Credit)	40%		-
Net Income		$	(7,500)
Cash Flow			
Net Income			(7,500)
Plus Depreciation			13,000
Free Cash Flow		**$**	**5,500**
Cash-on-cash (CoC) Return			*5.50%*
Inflation Adjusted Return			
Free Cash Flow		$	5,500
Change in Purchasing Power	3.0%		(3,000)
Inflation Adjusted Cash Flow			2,500
CoC Return (Inflation Adjusted)			*2.50%*
Unrealized Gain			
Inflation	3.0%		3,000
Outperformance above Inflation	1.0%		1,000
Total Unrecognized Capital Gain			4,000
Unrealized Gain			4.00%
Future Taxes			
NPV of Capital Gain and Depreciation Recapture			(1,704)
Return Drag from Future Taxes (NPV)			-1.70%

Return Summary	
Cash Return (Pre-tax)	5.50%
Cash Return (Adjusted for Tax Expense/Credit)	5.50%
Cash Return (Adjusted for Tax and Inflation)	2.50%
Unrealized Gain (Non-Cash)	4.00%
Return Drag from Future Taxes (NPV)	-1.70%
Total Return (Taxed)	7.80%
Total Return (After Tax & Inflation)	4.80%

Key Considerations for Loan Issuers

While this memo has focused on how taxes and inflation impact a loan's real return, there are numerous critical factors that investors should consider before issuing or investing in a private loan. Here is a brief list of some important considerations:

- **Margin of Safety –**Ensure there is a large margin of safety, such as a low loan-to-value (LTV) ratio or sufficient collateral, to mitigate the risk of loss if the borrower defaults. With no upside, loan issuers must be adamant about protecting their downside.
- **Debt Service –** Consider the source of income to service the interest on the loan. If the loan is against a property, where will the cash flow come from to cover the payments? For debt against real property – does the cash flow from the property (NOI) sufficient to cover the interest on the loan?
- **Repayment Source -** Understand where the repayment of the principal will come from. Will the borrower refinance, sell an asset, or use cash flow to pay back the loan?
- **Default Management -** Unlike more liquid investments, defaults on private loans can be costly and difficult to manage, especially for individual investors without a dedicated team to handle non-performing loans. The process of handling a non-performing loan can involve significant time, effort, and financial cost.
- **Legal Documentation:** Ensure that all legal documents, such as loan agreements and collateral documentation, are professionally vetted by legal experts. Properly structured legal agreements help protect the lender and mitigate risk.
- **Tax Impact –** Interest income from private loans is taxed as ordinary income, potentially reducing the return by 35-57%, depending on federal and state tax rates.
- **Inflationary Environment –** Inflation erodes the purchasing power of both a loan's interest income and the principal. In a high inflationary environment, this can significantly lower the return.

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Conclusion

Investors should be keenly aware that the interest rate alone does not provide enough information to evaluate a loan. The interest rate only represents the ceiling—the best a loan can perform—and investors may fare far worse once taxes, inflation, and default risks are considered. To make informed decisions, investors must thoroughly assess the loan's structure, potential risks, and the economic environment. They must understand how the interest income is taxed and how inflation may further erode their return. Private loans can offer attractive returns but require the same due diligence and prudent consideration as any other investment.

Best Regards,

The FFCM Team

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