Case Study

Net Lease & Private Credit: A Complementary Allocation

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Highlights

1. Income Taxation
2. Inflation Protection
3. Bankruptcy Protection
4. Capital Appreciation

Net lease real estate and private credit have gained prominence among investors seeking stable returns with reduced volatility. Amidst current US commercial real estate challenges, the appeal of potentially less risky real estate strategies like net lease has risen. Simultaneously, traditional corporate lenders are tightening their belts, leading to a growing interest in private credit as an alternative debt funding source.

Although they share some characteristics, the two diverge significantly in areas such as taxation, inflation protection, bankruptcy protection, and capital appreciation. This brief case study delineates the distinctions between net lease and private credit investments, illustrating how a strategic blend of both can seek to offer a balanced source of income with reduced volatility.

Income Taxation

Net lease real estate investments generally involve long-term, 15 to 20 year leases, with tenants responsible for property expenses like taxes, insurance, and maintenance, ensuring a steady, growing stream of passive income for landlords. The building is occupied by a single tenant that is credit worthy in nature and deems the asset as critical to their business operations.

From a taxation standpoint, net lease income often benefits from favorable tax treatment, including depreciation deductions and capital gains treatment upon property sales.

In contrast, income from private credit investments, like loans or bonds, may be subject to ordinary income tax rates, potentially leading to higher tax liabilities and lower tax-adjusted returns for investors.

Inflation Protection

A key advantage of net lease real estate investments is their inherent inflation protection. Net leases typically include provisions for periodic rent escalations, usually fixed annual increases or tied to inflation indices like the Consumer Price Index (CPI). These built-in increases help maintain long-term purchasing power of rental income, mitigating the erosive impact of inflation on investment returns and also serve as an elevated form of yield even if interest rates decline. In addition, hard assets like real estate have historically fared better in inflationary periods due to their intrinsic value.

Conversely, although private credit loans are generally floating rate in nature, they have little to no call protection, therefore, in a tightening spread or declining rate environment, lenders are likely to be repaid early or receive lower interest income.

Considering the topics of taxation and inflation, we believe blending these two asset classes can create a well-balanced yield segment in portfolios, offering an alternative solution alongside short-term cash investments vulnerable to inflationary erosion.

Bankruptcy Protection

In the case of a tenant's bankruptcy, we believe that risk mitigation is different in the net lease space and therefore can serve as a diversifier to private credit exposures.

First, bankruptcy law prioritizes rental payments to landlords, requiring tenants to pay rent in full as an administrative expense (i.e., pay current and before any other payments are made by the entity filing bankruptcy) unless and until such time as the lease is rejected. These payments ensure the continuity of the predictable and consistent cash flow that is the crux of a net lease investment. Conversely, both interest and principal payments on debt are suspended until the bankruptcy proceeding is concluded. In addition, net lease assets that are operationally essential are highly unlikely to be rejected because the continued use of the property is critical to the tenant as well as its customers and creditors **(Figure 1, page 3)**. Indeed, the focus of most bankruptcies is to jettison leases on underutilized properties and to restructure unsecured debt.

Second, the very nature of a net lease investment—the ownership of real estate—is unaffected by a tenant's bankruptcy. If a lease is affirmed, any lease defaults must be cured and kept current. If a lease is rejected, the tenant is required to pay all rent to the date of rejection and, importantly, to surrender the premises to the landlord on the date of rejection. After seamlessly obtaining control of the property, without the expenditure of costly legal fees, the landlord is not only free to sell or re-let the property, it also has an unsecured claim equal to the greater of (i) one year's rent or (ii) 15% of the balance of the contractual rent (not to exceed 3 years rent in the aggregate).

Private credit investments lack such protections and thereby expose creditors to a higher risk of capital loss since lease affirmations do not directly affect debt repayment obligations. The outcome depends on various factors, including the debtor's financial restructuring plan and court decisions, potentially diminishing recovery prospects for creditors.

Figure 1: Net Leases Mitigate Credit Risk

Corporate Lender

ABILITY TO SERVICE CORPORATE DEBT FACILITIES

Large percentage of the company's revenue is attributed to a specific building.

Customers

REVENUE GENERATION

Failure to fulfill these lease obligations will result in a loss of revenue and/or the incurrence of outsized capital expenses to replace production.

Tenant

FULFILLMENT OF LEASE OBLIGATION

During a bankruptcy event, a tenant is more likely to affirm the lease of a highly profitable facility.

Employees

ONGOING OPERATIONS

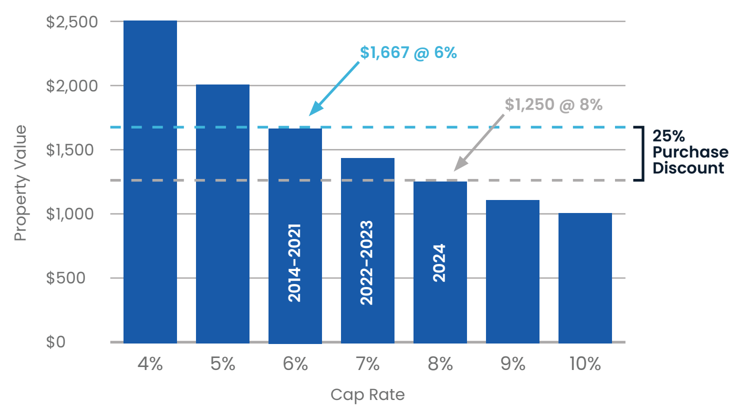
While corporate-level workouts are underway, continued production from these locations is necessary to preserve the financial health of the business.

Capital Appreciation

Net lease cap rates have remained relatively stable over the last 20 years, hitting a low of approximately 6% and peaking slightly above 8%. In the current real estate cycle (Figure 2), we believe prudent net lease managers have the chance to purchase net lease properties at lower prices compared to the last several decades, therefore, offering potential upside moving forward that enhances return outcomes alongside private credit allocations.

Coupled with this unique opportunity around entry point, amid economic uncertainty and market volatility, net lease properties have also historically demonstrated resilience thanks in part to their long-term call protection, which differs from private credit instruments as noted earlier. Triple-net leases with creditworthy tenants and fixed-rate financing seek to provide reliable and predictable cash flows, heightening their investment attractiveness, particularly in uncertain times and regardless of the interest rate environment.

Figure 2: Property Valuation at Various Cap Rates (NOI @ $100)



Overall, we believe the historical stability of net lease real estate, combined with attractive valuations for carefully underwritten transactions, presents an enticing entry point for investors seeking income-generating assets with defensive characteristics.

Figure 3: Summarizing Net Lease & Private Credit

	Triple Net Leases	Private Credit
Typical Target Distribution Range[1]	7–10%	7–10%
Income Taxation	Moderate: Income netted against depreciation	High: Ordinary income
Cash Flow Characteristics	Long-term, contractually based with rent escalators	Floating rate in nature with little to no call protection
Interest Rate Considerations	Increasing yield regardless of interest rate environment	Yield fluctuates based on interest rate environment
Bankruptcy Protection	High: Operationally critical asset promotes lease affirmation	Moderate: Senior lenders have risk of capital loss in restructuring

Conclusion

Net lease real estate and private credit have emerged as prominent alternatives within the investment landscape, offering investors stability and reduced volatility. The increasing appeal of potentially less risky net lease assets, coupled with the tightening stance of traditional lenders, has led to a growing interest in both as important investment solutions to consider. Despite sharing some characteristics, these two investments diverge in areas such as taxation, inflation protection, bankruptcy protection, and capital appreciation. Therefore, we believe a strategic combination of net lease and private credit investments can be viewed as a way to strengthen and diversify a portfolio.

Learn More

Watch our webinar "Is Now the Time for Net Lease? Assessing the Entry Point" to dive deeper into the current market landscape and learn about increasingly attractive opportunities across the net lease space.

Scan the QR code to watch.
Use passcode E%rhz5Hh.

US Realty Advisors is a 35-year-old investment management firm with a proven track record of delivering value by acquiring and managing single tenant, net lease real estate. The firm invests at the intersection of real estate and credit, providing investors with long- term, stable, inflation-hedged cash flows secured by operationally critical assets. With over $12.4B in closed transactions, $6.5B in AUM, and strong industry relationships, USRA is recognized as one of the most experienced net lease investment management firms in the US. Throughout the firm's history, USRA has demonstrated success and technical expertise in acquisitions, disciplined credit/real estate underwriting, and asset management.

[1]The typical target returns are based on our understanding of the current market. Such investments are, however, not without risk of loss.