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Whitepaper: Higher returns and lower risk? Yes, it's possible with private credit

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With the popularity of private credit understandably accelerating, a plethora of funds have emerged to meet the needs of investors seeking attractive returns, regular income, and low or no volatility.

How should investors compare the multiple offerings available? Typically, investors assess options based on returns, but this ignores a much more vital part of the comparison – risk. Two investors in private credit funds with the same yield may inherit very different levels of risk. For example, if both offer an annual nine per cent yield but one has lower risk, investors should eschew the higher-risk option and select the lower-risk fund for a better night's sleep.

A higher return usually means accepting higher risk, but the reality is more nuanced, and investors can benefit from identifying investment opportunities with higher returns and lower relative risk.

Fortunately, with the right tools and insights, private credit risks can be evaluated transparently. Aura Credit Holdings, the manager of the Aura Core Income Fund (the Fund), is leading the way by deploying bank-grade analytics to evaluate, manage, and disclose portfolio risk. We believe Aura Credit Holdings is the first private credit manager to engage an external risk analytics firm to conduct this assessment.

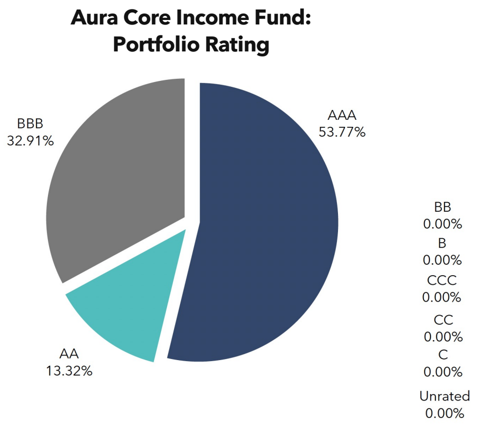
Independent, bank-grade risk modelling

What truly sets Aura Credit Holdings apart is the advanced Expected Credit Loss Model (ECLM) the company commissioned, employing the same rigorous framework used by the Australian banking sector. Supported by, and developed with more than 50 years of bank data, Aura's ECLM provides investors with a refined analysis of expected credit losses within the portfolio of loans and offers a reliable measure of portfolio risk.

This independent risk assessment enables a direct comparison of the Aura Core Income Fund (and the wholesale Aura Private Credit Income Fund) portfolio with the credit risks of public market securities such as corporate and government bonds, giving investors a clear and objective choice.

By incorporating and publishing bank-grade analysis, Aura Credit Holdings offers reliability, transparency and peace of mind.

Figure 1. Aura Core Income Fund portfolio: Equivalent to “AA” rating

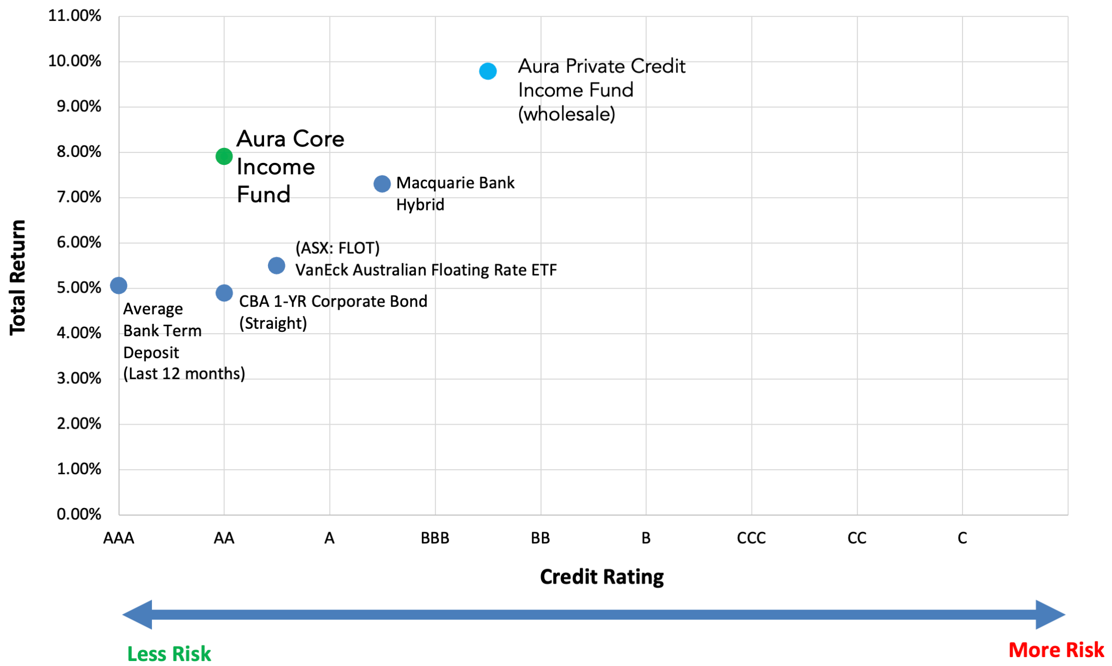


Credit Rating		
AAA	Capacity to meet its financial commitment is **extremely strong**	Investment Grade
AA	Capacity to meet its financial commitment is **very strong**	Investment Grade
A	Capacity to meet its financial commitments is **strong**. Somewhat susceptible to adverse economic conditions.	Investment Grade
BBB	**Adequate** capacity to meet its financial commitments. Vulnerable to adverse economic conditions.	Investment Grade
BB	Faces major ongoing uncertainties which could lead to **inadequate** capacity to meets its financial commitments. Vulnerable to adverse economic conditions.	Sub-Investment Grade
B	Adverse business or economic conditions will **likely impair** its capacity to meet its financial commitments	Sub-Investment Grade
CCC	Currently vulnerable and is **dependent upon favourable conditions** to meet its financial commitments	Sub-Investment Grade
CC	Currently highly vulnerable. **Default to be a virtual certainty.**	Sub-Investment Grade
C	Currently highly vulnerable. **Default to be a virtual certainty. Lower seniority and recovery.**	Sub-Investment Grade

Figure 1., reveals the conclusion of the ECLM’s risk assessment of the Aura Core Income Fund’s loan portfolio at June 30, 2024. With 54 per cent of the portfolio’s loans rated “AAA”, 13 per cent of the portfolio rated “AA”, and the remaining 33 per cent of the portfolio rated “BBB”, the Aura Core Income Fund receives an overall credit risk rating of “AA”. This is considered very low risk, and it means the Aura Core Income Fund’s capacity to meet its financial commitments is very strong.

With the “AA” rating, investors can assess the Aura Core Income Fund against other publicly traded securities with the same rating. Investors can also compare the risk ratings of other securities promising or promoting similar returns to the Aura Core Income Fund.

Figure 2. Relative risk and reward. Returns 12 months to 30 September 2024



Portfolio credit risk statistics calculated by a third-party risk consultant as at 30 June 2024. Subject to change.

Return of CBA corporate bond calculated via Bloomberg by the compound return of the 3-month bank bill swap rate (BBSW) + 0.47 per cent spread over the 12 months to 30 September 2024. Return of Macquarie Bank hybrid calculated via Bloomberg using total return of price return + coupon return (3-month BBSW + 4.90 per cent spread) over the 12 months to 30 September 2024.

ASX: FLOT return sourced from vaneck.com.au and reflects the one-year total return for month ending 30 September 2024, assumes the reinvestment of distributions and net of management fees and costs but excludes brokerage or bid/ask spreads.

Figure 2., reveals the relative return of the Aura Core Income Fund over the 12 months to 30 September 2024. On an income reinvested basis, the return to investors was 7.91 per cent after all fees and expenses. Figure 2., allows investors to compare this 7.91 per cent return against the return of other securities with the same risk rating and the returns of securities with higher risk ratings.

Figure 2., reveals investors in securities with similar (A+ to AA) risk levels received a total return of 5.0 per cent to 5.4 per cent for the twelve months to 30 September 2024, materially lower than the return offered by the Aura Core Income Fund.

Indeed, investors in the Aura Core Income Fund effectively adopted the same credit risk as investors in the CBA 1-yr Corporate Bond and the VanEck Australian Floating Rate ETF, but earned a return that was between 2.5 per cent and 2.9 per cent higher over the year.

Further, Figure 2., reveals investors in a Macquarie Bank Hybrid adopted more risk but received a lower return for the period than investors in the Aura Core Income Fund.

The Aura Core Income Fund's expected credit loss (ECL) is in line with an "AA" equivalent investment and is supported by very low 30-day loan arrears, which at 30 September 2024, was running at a low 0.61 per cent.

This loan arrears figure represents the percentage of borrowers who are 30 days or more behind on their repayment commitments. It's a useful measure for the manager to predict individual loans that are more likely to default in the future.

The Aura Core Income Fund's 30-day arrears figure sits favourably against the arrears figures published by other lenders. For example, on 7 November 2024, the National Australia Bank reported to the Australian Securities Exchange (ASX) that 1.82 per cent of its residential mortgage book was 30 days or more in arrears, while the bank's total lending book – comprised of mortgages (56 per cent), business loans (42 per cent) and unsecured lending (2 per cent) – had a 90-day arrears rate of 1.36 per cent.[1]

Aura Credit Holdings is highly disciplined in its selection of non-bank lending partners. The Aura Core Income Fund finances only four high-quality Australian specialist lending organisations after screening and assessing more than 150 potential partners over the last seven years.

Further layers of protection provide comfort

Additionally, the structure of Aura's loan pools ensures multiple layers of credit protection for the Aura Core Income Fund and explains why the unit price has never fallen, nor varied from $1.00, after each the monthly interest payment, since the Fund's inception.

The Fund has several layers of protection to manage risk and secure investors' returns.

First layer: careful loan selection

Before a loan is granted, the Aura Core Income Fund's lenders evaluate each applicant judiciously, ensuring they only lend to financially strong businesses seeking to grow. Successful applicants are currently assigned loan-to-value ratios (LVRs) of up to 80 per cent, meaning the loan amount is no more than 80 per cent of the business's asset value. The Fund also diversifies its portfolio across various industries and regions to spread risk.

Second layer: loan security

Each loan in the Fund's portfolio is backed by security, giving the lender a legal right to claim certain assets if a borrower fails to repay. A General Security Agreement (GSA) allows the lender to register its interest in a borrower's assets – both tangible (including but not limited to property, machinery, vehicles, and inventory) and intangible (such as intellectual property and trademarks). The lender could claim these assets to recover unpaid loan amounts if necessary. A Director's Guarantee also renders the business's director(s) personally liable for loan repayment. The Fund focuses on ensuring the value and validity of these securities at the time of origination to safeguard investor funds. In cases of late payment, the Fund may also charge penalty fees to cover recovery costs.

Third layer: partner structure and risk sharing

Rather than lending directly to borrowers, the Fund's loans are held in separate "warehouses" managed by non-bank lending partners, who share in each loan's financing. The lending partner holds a minority stake and takes on the "equity note" or most junior position, meaning they absorb any initial losses. This structure means the lending partner's stake is impacted first in the event of a loan default. Only after the partner's stake is exhausted would the Fund's income distributions to investors be impacted. Currently, this "first loss" protection averages 27.5 per cent, meaning that over a quarter of the Fund's loans would have to default and lose 100 per cent of the recoverable value before investors' monthly income or unit value ($1.00 per unit) would be affected.

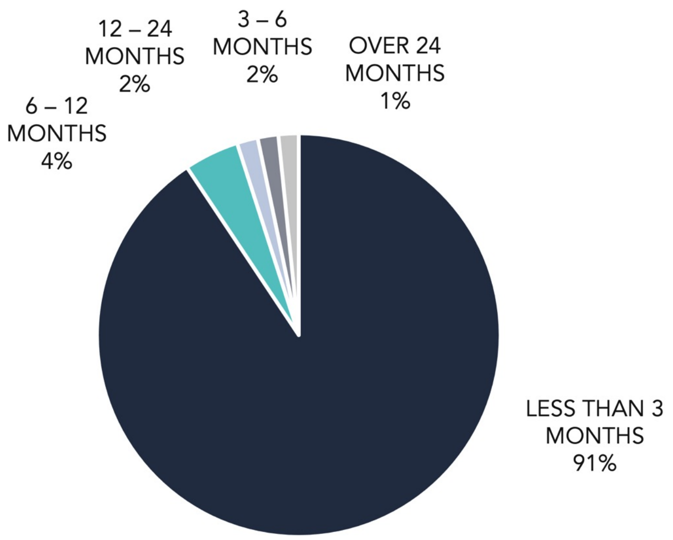
Final layer: bankruptcy protection

The loans in each warehouse are held in separate Bankruptcy Remote Trusts. This structure means that even if a lending partner falls into bankruptcy, the loans in the warehouse remain unaffected, effectively owned by the Fund, and the Fund and its investors continue to receive interest payments for the loan term.

Shorter loan duration offers protection and flexibility

As published in the September 2024 Monthly Report for the Aura Core Income Fund, 91 per cent of its loans have a duration of less than three months, and an additional 6 per cent have a duration between three and twelve months. This short-term bias helps the Fund maintain liquidity, making it easier for investors to access cash quickly if required. It also lowers both the credit risk (the risk of borrowers not repaying) and interest rate risk associated with these loans.

Figure 3. Aura Core Income Fund duration mix at 30 September 2024



One of the concerns on the minds of almost all market investors is what happens if a deep recession occurs. With a duration of circa three months, at 30 September 2024, even if the Fund were to stop recycling its capital into new loans hypothetically, and demand from investors for a return of their funds was vast, investors would receive 91 per cent of their funds within three months. This might be regarded as preferable to other funds whose portfolios have two and three-year average durations, meaning investors might have to wait up to three years for a return of their funds.

While public assets allow for daily trading, private credit requires a longer commitment. The Aura Core Income Fund balances this by offering monthly liquidity so investors can access their funds regularly without diminishing the potential returns or the stability of the unit price. Patience rewards private credit investors with higher potential returns, which is especially appealing when yields elsewhere are lower.

Conclusion

A leader in transparency and empowering investors, Aura Credit Holdings sets a high standard in private credit by taking a proactive, bank-grade approach to risk. This dedication to clarity lets investors fully appreciate the strategic advantages of private credit as a valuable and even necessary portfolio component.

Aura doesn't focus exclusively on absolute returns; it offers investors a deep understanding of their risk-return profile, positioning the Aura Core Income Fund as an informed and powerful addition to any investment strategy.

Through Aura Credit Holdings and Montgomery Investment Management, investors can select from two Funds combining private credit's high return potential with sophisticated risk management rigour. These Funds uphold lending standards comparable to those of highly-rated publicly traded assets, offering a unique opportunity in the private credit asset class for investors seeking superior risk-adjusted returns.

The Aura Private Credit Income Fund (available to wholesale investors) has made 86 monthly payments to investors since its 1 August 2017 inception. These monthly payments have averaged 0.77 per cent and ranged between 0.60 per cent and 0.93 per cent. The Aura Private Credit Income Fund has delivered a compound annual return of 9.64 per cent after all fees and expenses, assuming reinvestment of monthly distributions, since its inception to 30 September 2024.

Aura's unwavering commitment to independent, rigorous analysis and self-assessment means investors are equipped with the insights and tools to build portfolios designed for sustainable, risk-adjusted returns, via reliable monthly income.

[1] National Australia Bank, "2024 Full Year Results" and "Investor Presentation", ASX Announcements, 7 November 2024. Retrieved from ASX.

More information

For more information or to invest in the Aura Core Income Fund, or the Aura Private Credit Income Fund (for wholesale investors) please reach out to David Buckland, CEO, or Rhodri Taylor, Account Manager, at Montgomery Investment Management on 02 8046 5000 or email investor@montinvest.com.

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