Private credit: Unpacking and navigating the risks

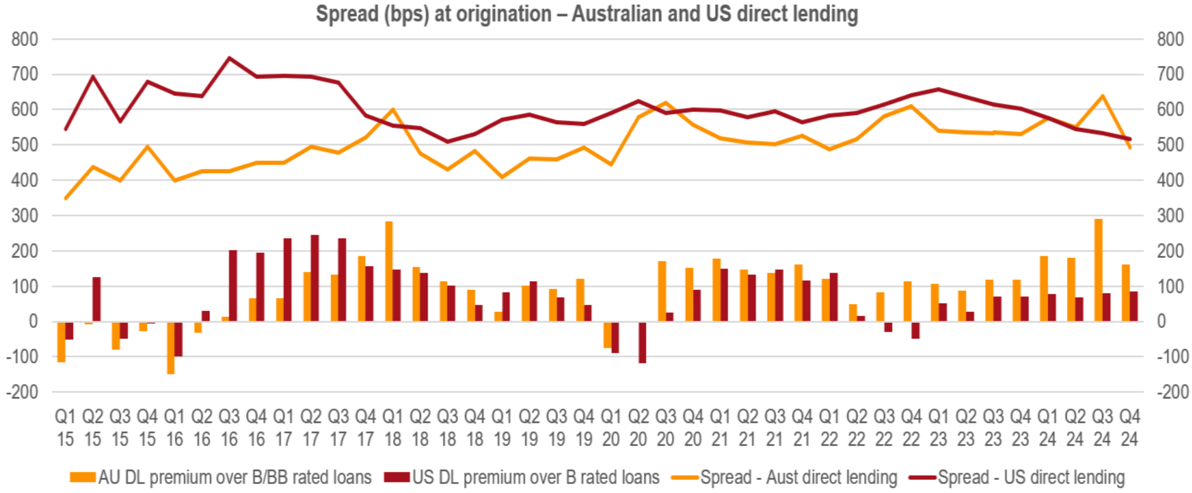
June 2025

Direct lending manager survey

Nam Tran, Senior Consultant at Frontier Advisors, unpacked the results of Frontier's latest direct lending manager survey. Key takeaways from the survey are outlined below.

Direct lending – credit spreads

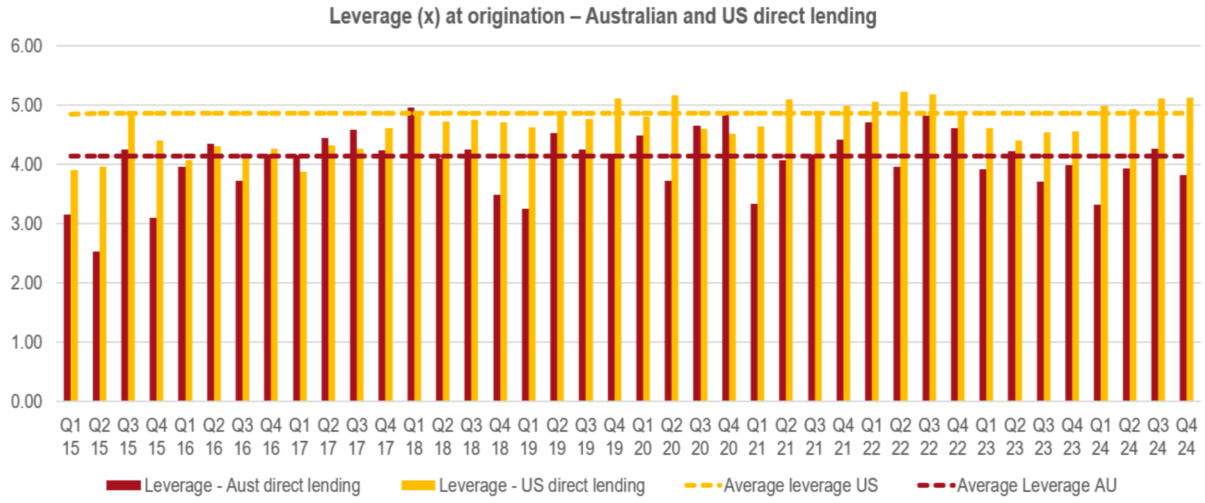
- A distinguishing feature of private credit is the income, which is driven by credit spreads.
- In the past 18-24 months, spreads have been contracting in both Australian and US direct lending markets. The compression, however, has not been as sharp as observed in liquid credit.
- Over the last two years, the premium over liquid credit has been increasing in both the US and Australia. Australian direct lending transactions currently offer a more attractive premium than the US.



Source: Frontier Advisors' direct lending manager survey, S&P UBS Leveraged loans index. S&P UBS leveraged loans data is average quarterly figure.

Direct lending – leverage

- Leverage used by borrowers in Australia is very well controlled and is below the long-term average.
- In contrast to that, leverage in the US has been increasing and is currently above 5x, above the long-term average, and this indicates a rising risk profile.



Source: Frontier Advisors' direct lending manager survey

Defaults, losses and returns

- Default rates have been increasing and while some additional loss will result, overall loss given default remains very modest.
- Returns have remained solid, driven by the credit spreads and the low loss rate.
- As of December 2024, returns of the 2022 and 2023 vintages are noticeably higher than returns of previous vintages, driven by a higher base rate.

Panel discussion

A panel discussion followed Tran scene setting opening and featured Peter Williams, Senior Portfolio Manager, Credit, VFMC; Lillian Nunez, Co-Head of Australian Diversified Credit, IFM Investors; and Andrew Kemp, Deputy Director of Research and Head of Private Markets, Frontier Advisors.

Assessing the risks in private credit

Williams noted credit assessment should cover multiple aspects of a lending transaction and due diligence should consist of several interrelated work streams. He mentioned counterparty analysis, structural analysis, document analysis, financial and scenario analysis, and exit and recovery analysis as areas of his focus when assessing the risks.

Kemp added that private credit covers a wide range of risk profiles and assessing the risk is challenging, noting investors can't just look at volatility of returns, they need to consider multiple measures of risk (e.g. debt to earnings). He believed the risks were more visible in older vintages where loans were done in very different market conditions to now. Risks associated with recent transactions were manageable.

Media attention and increased regulatory scrutiny

On recent media attention and increased regulatory scrutiny for the asset class, Nunez highlighted the concerns are valid but possibly omit the positives (e.g. private credit provides essential capital for Australia to grow). Regulatory scrutiny is appropriate given the number of constituents in the industry has grown. The industry needs to ensure consistency in measuring the different players in the sector.

Williams acknowledged there has been a lot of capital flowing into direct lending and he believed investors could look into other sub-sectors within private credit, outside of direct lending where capital inflow has not been as high.

Future defaults and sectors more at risk of defaults

Kemp anticipated that defaults may further increase given the challenging operating macro environment. However, defaults are idiosyncratic in nature and a wave of defaults is unlikely to occur.

When quizzed on sectors that may be more at risk of defaults, Nunez highlighted some businesses that were previously supported during COVID-19 are now coming under pressure. Nunez flagged the healthcare and construction sectors are two industries potentially more at risk of defaults, given structural headwinds.

Next steps

Frontier believes direct lending continues to offer a reasonably attractive return. However, the combination of lower base rates, moderately tighter credit spreads and an uptick in defaults is likely to moderate future returns somewhat.

Frontier will release its direct lending insights paper shortly. Clients should review the insights paper and talk to Frontier on how the insights can be applicable for their private credit portfolio. For further information about this topic and how Frontier can help in managing private credit allocations, contact Andrew Kemp, Deputy Director of Research and Head of Private Markets at akemp@frontieradvisors.com.au.