

The Frontier Line

Lower returns ahead for private credit

Assessing shifting dynamics
in the current environment

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About us

Frontier Advisors has been at the forefront of institutional investment advice in Australia for thirty years and provides advice on around \$800 billion of assets across the superannuation, charity, public sector, insurance and university sectors.

Our purpose is to empower our clients to advance prosperity for their beneficiaries through knowledge sharing; customisation; technology; and an alignment and focus that is unconstrained by any product conflicts.



Andrew Kemp

Deputy Director of Research
and Head of Private Markets

Andrew Kemp joined Frontier Advisors in 2016 and is the Deputy Director of Research and Head of Private Markets. Andrew has oversight for the specialist advice in fixed interest, currency, derivative overlay and alternatives segments while his team undertakes research and ratings on private asset classes including private debt and equity. Andrew has more than twenty years of experience in the asset management industry both domestically and globally, having worked in Australia, Singapore and the UK. Prior to joining Frontier, Andrew worked for a decade at AllianceBernstein Australia as a fixed income portfolio manager, spent three years as Head of Fixed Income at DBS Asset Management in Singapore and then joined Chimaera Capital as Director of Asset Management, primarily in Singapore. Andrew holds a Bachelor of Commerce (Finance) from Otago University (NZ) and a Graduate Diploma of Applied Finance and Investment from Finsia.



Nam Tran

Senior Consultant

Nam Tran joined Frontier in 2017 as a Consultant, was promoted to Senior Consultant in 2021. He is a senior member of the Defensive Assets and Private Markets Team with a focus on private markets. Previously Nam worked with NAB in the institutional banking area, undertaking industry and credit analysis in the resources, energy and utilities sectors for ten years.

Prior to this, he spent three years with KPMG and the Sarbanes Oxley team at NAB, undertaking financial and operational analysis of clients in the financial services industry, and three years with HSBC in Vietnam in corporate and institutional banking. Nam holds a Bachelor of Business from Monash University, a Master of Commerce from the University of Sydney, and is a CFA charterholder and CAIA charterholder.



Jill Guan

Senior Consultant

Jill Guan joined Frontier as a Consultant in 2021 and promoted to Senior Consultant in 2023. She is a member of the Defensive Assets and Private Markets Team. Jill was previously at Citibank Australia where she provided relationship and credit coverage to institutional clients. She has also spent time in China with Citibank as a Credit Analyst. Prior to that, she worked at HSBC Australia and ANZ within institutional banking across various client coverage teams. Jill holds a Bachelor of Law and a Bachelor of Commerce from the University of Melbourne.

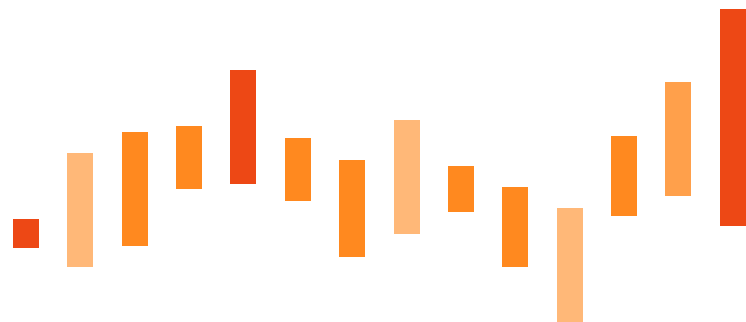
Introduction

Private credit has grown exponentially to an unprecedented market size and provided investors with strong returns fuelled by a combination of elevated base rates since 2022; robust credit spread premia; low loss rates; and attractive origination fees.

In this report we consider if the favourable environment for private credit is now showing signs of change and if the performance of private credit funds is likely to face some headwinds ahead.

The market has grown tense amid a challenging economic and geopolitical environment, uncertainty around President Trump's administration policies, and increased retail investor capital in Australia. With the health of the asset class in question, negative media on problem loans, caution from research houses has increased and ASIC has flagged "failures of private credit markets are on the horizon".

While private credit remains a compelling asset class, a closer examination of key drivers of returns including spreads, fees, and risk/default are warranted in the current environment.



Frontier's private debt research

With high levels of market noise it is important to focus on the underlying asset quality, though the opacity of available data has historically made this difficult to evaluate.

Frontier has done extensive research on private credit since its infancy including an annual direct lending survey, which collates data from over 30 well-known Australian and global direct lending players in the market. This year, the survey was broadened to include property debt, which can offer different characteristics to corporate direct lending. The survey covers over 6,500 corporate loans originated between 2015-2024 including 1,200 deals from last 12 months. We gather essential fund-level data alongside detailed loan-level deal metrics which validate trends, interrogate areas of concern, and provide deeper insights into the sector's progression. This paper presents the latest developments of the private credit market focussing on direct lending and property debt based on survey findings, highlighting shifting themes and areas of continuity. Additional perspectives from this year's property debt survey have also been incorporated to highlight trends in risk and return.

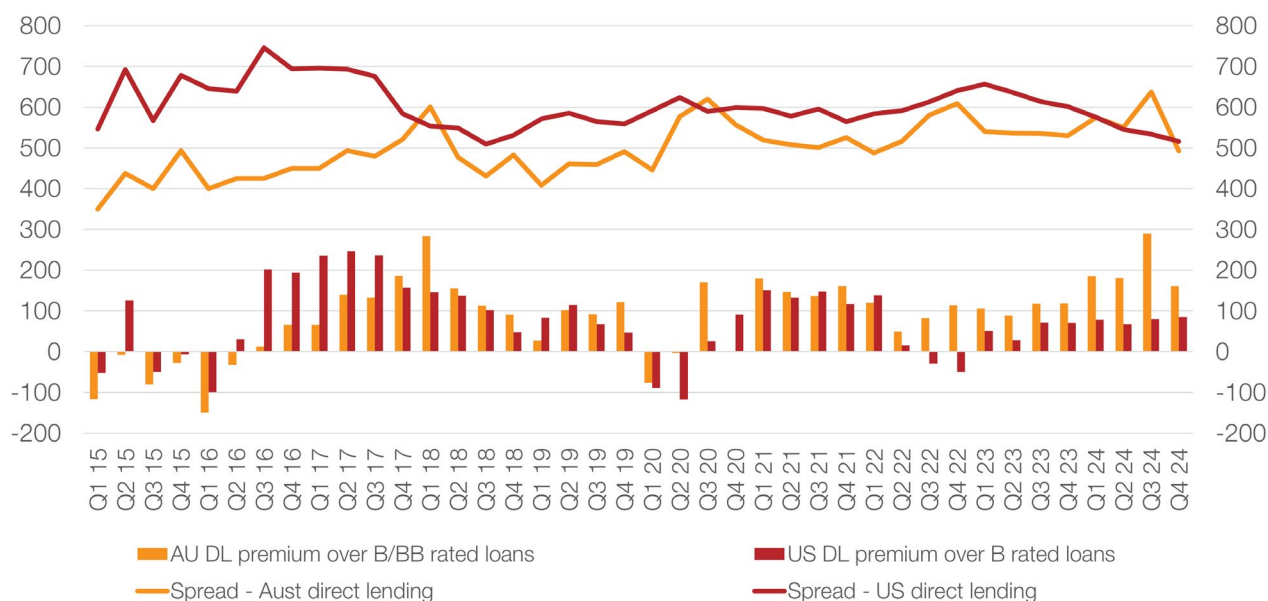
Credit spreads for new loans across all markets have contracted

Credit spreads in most markets have continued to narrow in the past 12 months in the range of 50-80bps and remain loosely correlated to liquid credit spreads despite a lag.

Spread compression has been most pronounced in the US, narrowing to its lowest level since 2018 as shown in Chart 1. The spread decline is driven by strong competition among lenders, spread compression in sub investment grade liquid credit markets and limited deal flow from muted M&A activity.

Despite the spread compression in US, direct lending continues to offer reasonable illiquidity premium in the range of 80-100bps versus the closest comparable liquid credit markets in US, albeit lower than the historical range of 100-200bps.

Chart 1: Spread (bps) of US senior direct lending has narrowed to its lowest level since 2018



Source: S&P/UBS, Frontier Advisors' direct lending manager survey. S&P /UBS Leveraged Loan data is the average quarterly figure. 1st Lien is inclusive of unitranche deals. The box spans from 25th percentile to 75th percentile of data set.

Upfront origination fees have dropped in US and Europe, reflective of increased competition

Direct lending deals receive an upfront compensation often paid in the form of a discounted issuance price (often referred to as original issue discount or OID).

A large fall in US upfront fees was notable in 2024 as higher competition for deals eroded the upfront origination fees earned by managers. While Europe has historically offered a greater level of upfront fees, this year's survey highlights a sharp decline in line with the US market. This may represent more capital flowing into European deals because of the Trump administration policies, or simply better relative value opportunities in Europe reflecting the complexity of a more fragmented market. Competition in the US and Europe is strong with a high number of direct lending funds in the market. While there are numerous players in these markets, many are small and sub-scale. Established players continue to dominate the market in terms of fund raising and deal execution, and benefit from an 'incumbency' advantage of lending to existing portfolio companies that require new financing or refinancing.

Upfront fees in Australia have remained more consistent as the market is relatively fragmented, and credit funds typically compete with both banks and other institutional investors (i.e. superannuation funds).

Table 1: Upfront fee by origination year

Region	2022	2023		2024		Avg 2022-2025
Australia	2.00%	2.16%	↑	2.11%	↓	1.90%
Europe	2.89%	2.93%	↑	2.31%	↓	2.49%
USA	2.11%	2.33%	↑	1.30%	↓	1.72%
Average	2.33%	2.47%	↑	1.91%	↓	

Source: Frontier Advisors' direct lending survey

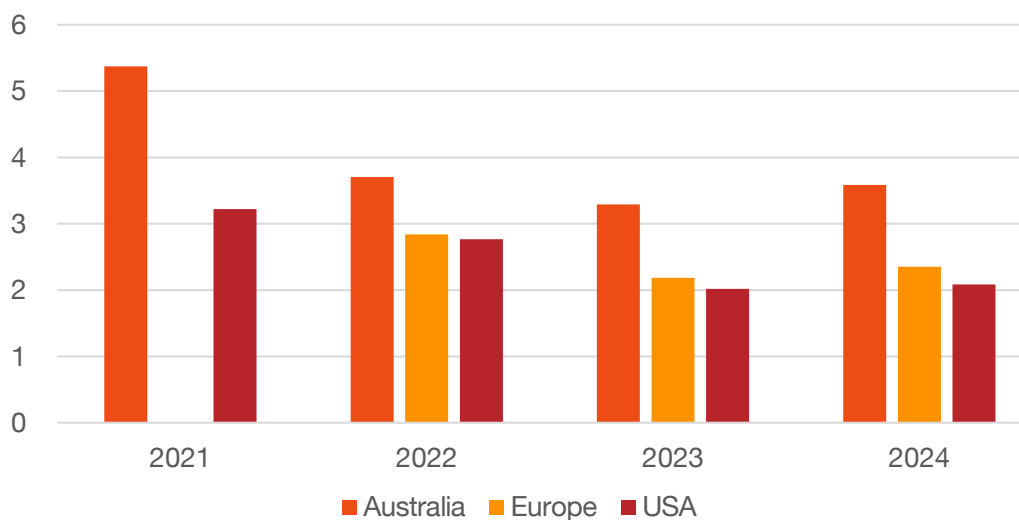
Some signs of weakened credit fundamentals noted but equity cushion has strengthened

Across the portfolios surveyed, rising interest expenses from higher base rates have translated into lower profit margins which has put strain on company cashflows.

As a result, there has been an uptick in loans on 'credit watchlists' for existing portfolios.

Chart 2 shows the average interest cover ratios (ICR), which measures a company's ability to service its interest expenses on outstanding debt of deals originated between 2021 and 2024. The ICR was lower for deals made in 2022 and 2023 compared to 2021, mainly because of higher base rates. As rates eased in 2024, the ICR began to stabilise.

Chart 2: Interest coverage (x) of deals collected by origination year



Source: Frontier Advisors' direct lending survey

Chart 3 shows the average equity cushion which refers to the buffer of equity that protects lenders of newly originated deals between 2015 and 2024. Equity cushion has improved over time, suggesting strengthened downside protection.



Source: Frontier Advisors' direct lending survey

While credit fundamentals have deteriorated for some borrowers, it is more reflective of idiosyncratic reasons as opposed to any widespread industry challenges. Direct lenders continue to prioritise and invest in borrowers with stable cash flow in more resilient sectors such as healthcare, insurance, business services, consumer services, IT services and software with limited exposure to cyclical industries such as retail, energy, metals/mining, and transportation.



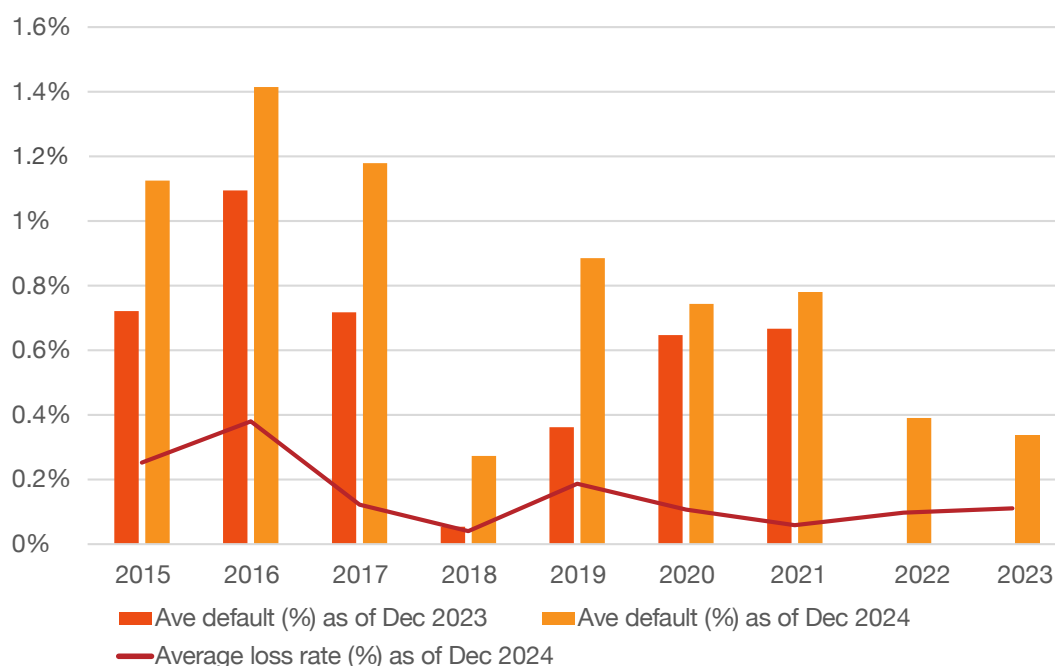
Defaults have increased from last year, but a complete picture is yet to emerge

Although long-term average default rates remain modest and lower than those in liquid credit markets, Chart 4 shows a slight increase in annualised default rates (measured from 2023 and 2024) across most fund vintages.

The rise is more evident in vintages before 2020, which were more affected by COVID-19 and rapid interest rate hikes. Pleasingly, loss rates which are key to fund performance remain low, illustrating effective default management by managers.

However, measuring and comparing defaults and losses remains difficult. Recent trends in liability management exercises (LME), which are a form of balance sheet restructuring often outside of formal bankruptcy proceedings, have potentially staved off larger defaults in both the liquid and private credit markets. Reported default rates may not be fully reflective of the actual levels of borrower stress in portfolios unless loan amendments by borrowers due to financial stress are included. Going forward, we believe investors should look at both default rates provided by their managers and be aware of any change in 'unofficial' defaults which are presented as 'amend and extend' transactions, such as LMEs.

Chart 4: One-year change in average default rate and loss rate (%) by vintage year



Source: Frontier Advisors' direct lending survey, default rate defined as \$ of defaulted loans / \$ of invested capital

Spread by market segmentation is converging in the US

The global direct lending market, particularly the US, has become more segmented and is no longer limited to loans for small and mid-sized borrowers.

Private credit (direct lending) is now an integral part of the financing for large-sized borrowers, including those with an average EBITDA \$100-150m and above. Previously, there was a clear differentiation between the spread premium offered based on business size. This has changed, with credit spreads across the various segments in the US market converging – likely due to increased lender competition. Except during periods of extreme market stress when liquid credit markets were closed, credit spreads in the upper market were typically lower than in the middle market. This was because smaller businesses were seen as riskier and offered higher spreads to compensate. However, since 2023, spreads across most market segments have levelled out (see Chart 5).

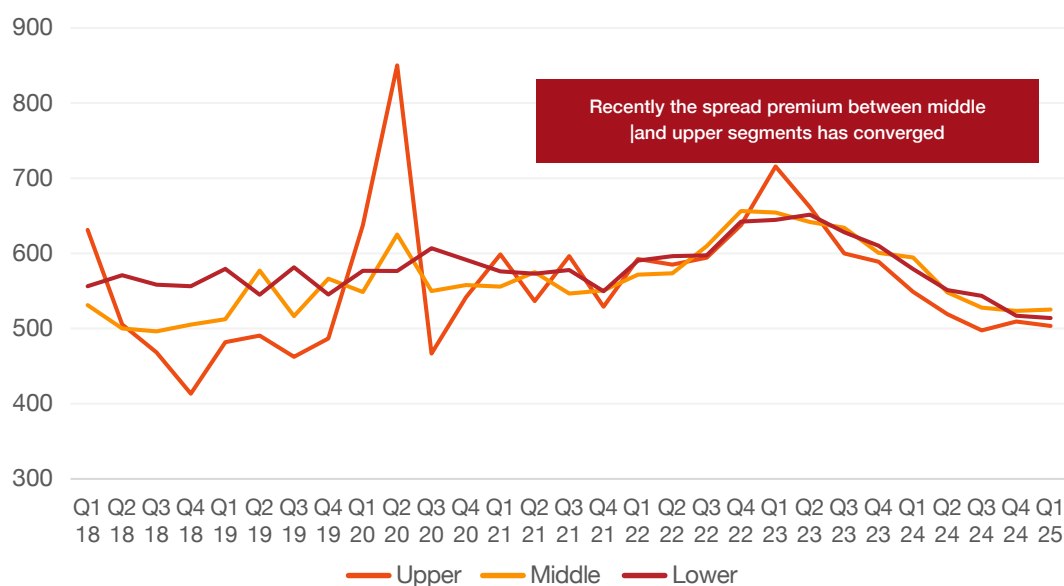
On a spread per leverage basis, the upper segment generally has lower spread per ‘turn’ of leverage due to higher leverage accepted for borrowers in that segment. In contrast, the lower segment typically has most favourable spread per turn of leverage due to lower leverage accepted in that segment. Chart 6 shows how spreads per unit of risk have evolved over time noting the lower segment typically shows a higher risk-adjusted return.



The question of which segment to lean into is a complex one, and investors need to ensure they consider other important factors such as volatility, product structure, financial structure and fees before making investment decisions.

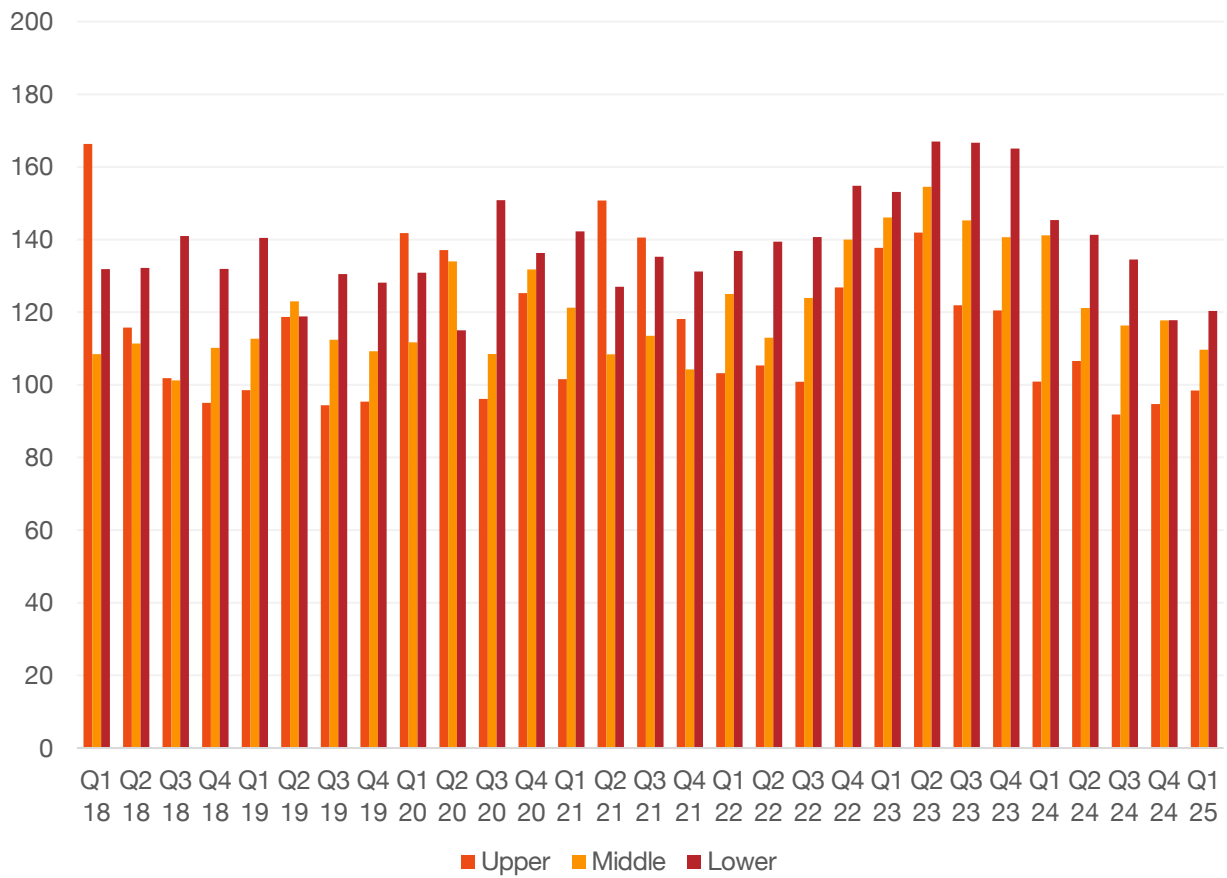
Manager selection is critical. Amid the surge of new entrants to the direct lending market especially in the US market, investors should seek well-established managers with a proven track record.

Chart 5: Converging credit spreads (bps)¹



Source: Frontier Advisors' direct lending survey, 1st Lien is inclusive of unitranche deals.

Chart 6: Average spread per turn (1x) of leverage (bps)¹



Source: Frontier Advisors' direct lending survey, 1st Lien is inclusive of unitranche deals.

¹ Frontier has defined the lower market segment as borrowers with an EBITDA of \$25m or less, the middle market segment as borrowers with an EBITDA between \$25m and \$100m, and the upper market segment as borrowers with an EBITDA of \$100m and above.

Covenant-lite loans remain a feature of the upper middle market in the US

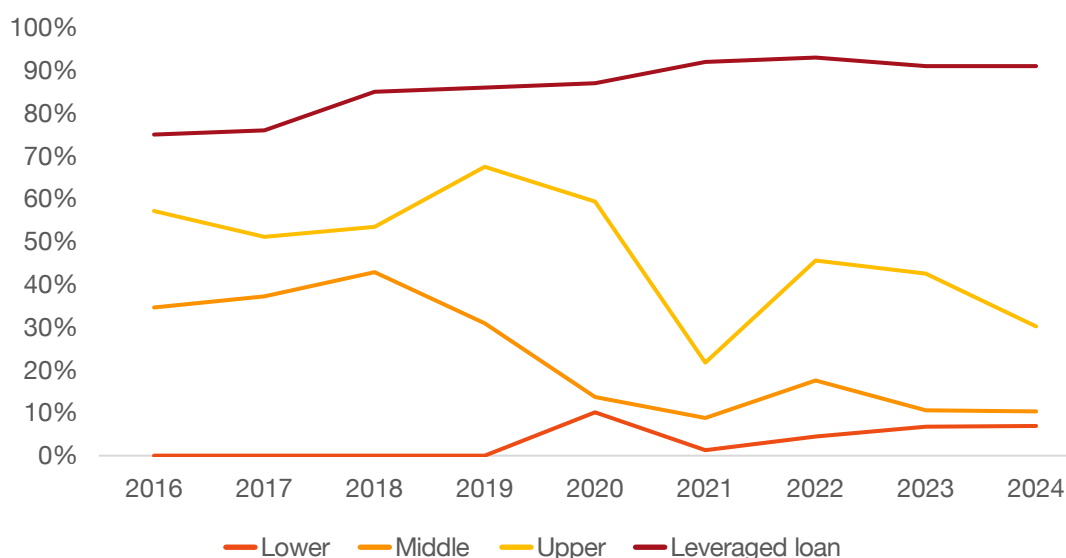
Another trend observed in the direct lending market is the adoption of covenant-lite (cov-lite) loans (i.e. loans structured without maintenance covenants to protect lenders), which is a feature of the broadly syndicated loan market.

In line with our observations in the past, the emergence of cov-lite structures is less apparent in the lower or middle market, which continue to benefit from more covenant protection. Notably almost all loans in the lower middle market are still structured with at least one maintenance covenant. In Australia, we have observed several cov-lite transactions in loans structures for large-sized borrowers.

Based on our survey, roughly 30% of loans within the upper segment are cov-lite loans whereas that percentage is less than 10% for the middle segment and almost none in the lower segment. This is reflective of large-size borrowers using direct lending as an alternative source of funding and can negotiate the types of cov-lite structures normally used in the leveraged loan market.

While cov-lite structures are more borrower-friendly, they do not necessarily indicate higher risk or higher probability of default as borrower stress is more idiosyncratic and is dependent on a range of other factors (e.g. quality of management, business strategy, supplier/customer relationship). Ultimately recovery is dependent on quality of credit documentation, capital structure, quality of sponsors (in the case of sponsored transactions) and manager's skill in managing credit workouts. Having said that, investors should be aware of the underlying credit quality of cov-lite loans found in their portfolios, how risks are managed, and understand the monitoring processes particularly for borrowers with high leverage with signs of underperformance. Investors should also be aware of other features of loosely structured loans which can be more prone to liability management exercises as observed in the broadly syndicated loan market.

Chart 7: Percentage of cov-lite loans by market segmentation



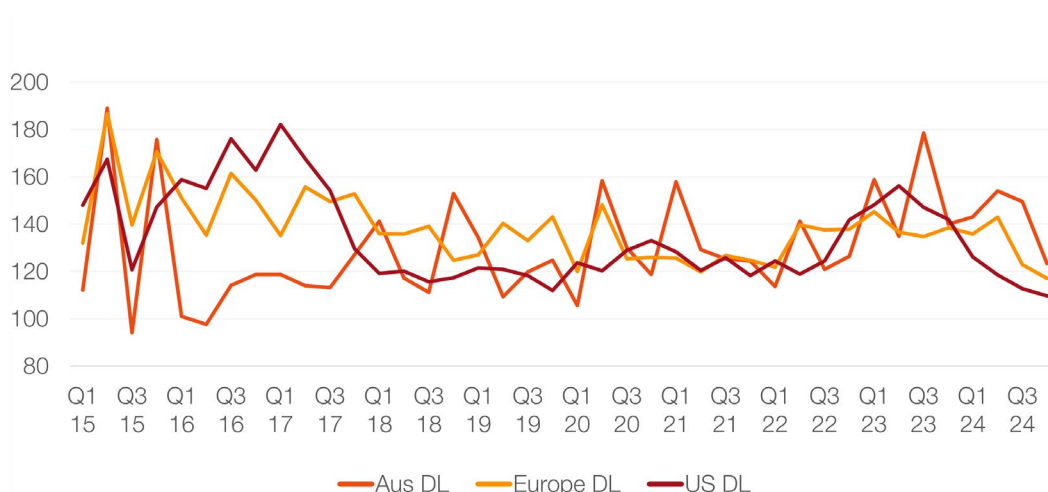
Source: Frontier Advisors' direct lending survey, 1st Lien is inclusive of unitranche deals.

Australia offers higher spread per unit of risk

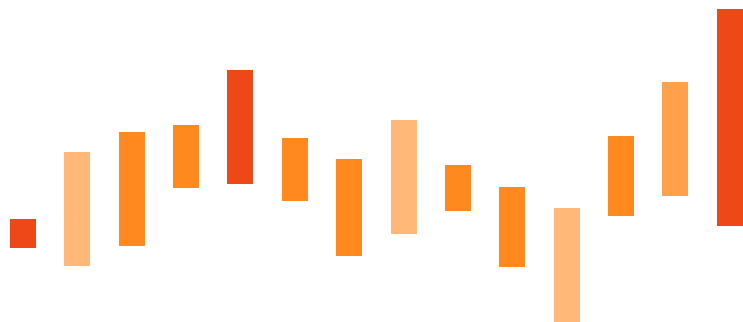
Chart 8 shows a comparison of spreads per turn of leverage which measures return per unit of risk across various markets.

While this has fallen across all geographies because of the decline in spread, Australia continues to offer higher spread per turn of leverage relative to global markets as deals are generally structured more conservatively with lower leverage.

Chart 8: Average spread (bps) per turn (1x) of leverage



Source: S&P LCD, Frontier Advisors' direct lending survey, 1st Lien is inclusive of unitranche deals



Market observations from the property debt segment

As more investors start to seek diversification within private debt, property debt has been on the radar.

There is a varying degree of risk and return in property debt depending on the underlying asset and deal type; with loans to established properties typically carrying lower risk and return relative to construction loans.

In addition to spreads, property debt managers also earn compensation through an origination fee (i.e. upfront fee) and a line fee (payable as a percentage of total facility limit) in markets such as Australia and Europe. Line fees are particularly high for construction loans in Australia and are a key component of the return profile.

Chart 9: Australia: effective spread by property sector (%)¹



Source: Frontier Advisors' property debt manager survey, ¹Non construction includes both core-plus and value add.

²Effective spread includes an estimated impact of line fee based on average utilisation of ~65% and line fee of 3%.

Based on Frontier's manager survey, while the default rate of property debt has been high in certain vintage years (e.g. 2017, 2020) due to higher exposure to sectors with challenging fundamentals such as office, average loss rates have been manageable. This can be attributed to certain risk mitigants of property debt such as:

- Average LVR (loan to value ratio) across all markets has been around ~60%, providing significant downside protection.
- Majority of property debt deals are done bilaterally, providing the lender with influence over terms and conditions and the ability to manage any issues that may arise.
- Almost all transactions are structured with maintenance covenants, providing lenders with early warning indicators and the ability to act to manage the loan.

The final word



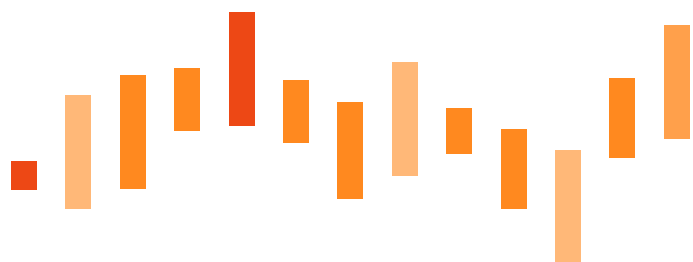
Historical performance of direct lending has been strong and driven by relatively stable credit spreads, elevated base rates, modest defaults and minimal loss.

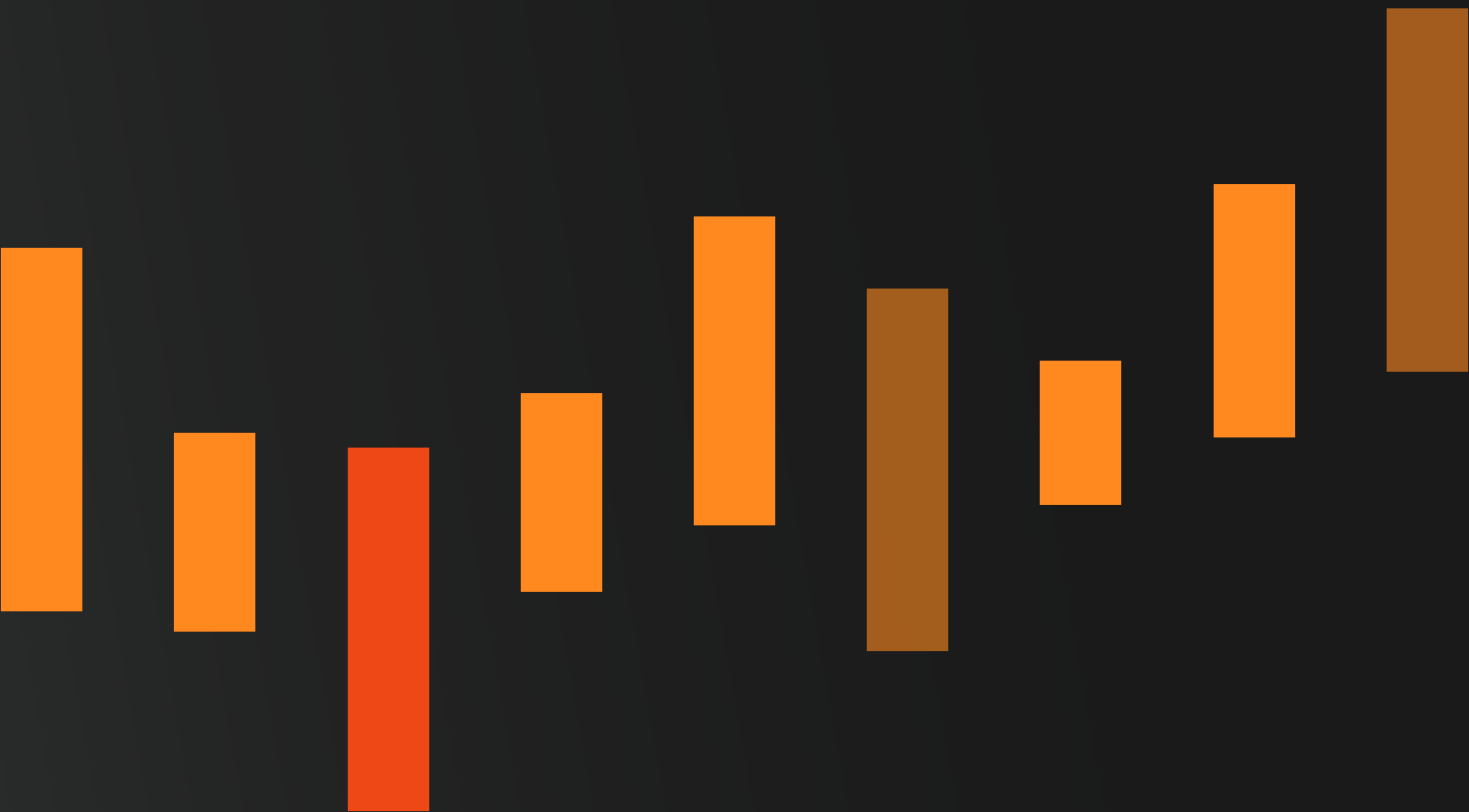
Looking ahead, direct lending in our view is unlikely to replicate the strong returns in the last three years but should still provide a steady income stream. While portfolio risks have increased in certain borrower segments, downside protection remains intact, translating into modest default and loss rates at this juncture despite a modest increase from last year. Defaults may rise further driven by idiosyncratic borrower risks and will test managers' skill on managing losses. Direct lending should remain a core allocation of investment portfolios in our view. Investors should be mindful of the headwinds facing fund returns, including lower base rates, tighter credit spreads and the need to closely monitor underlying default risks within portfolios.



Learn more

Frontier can help with portfolio construction and has extensive coverage of Australian and offshore direct lending strategies. We would be pleased to share additional insights and discuss any aspect of this asset class with interested investors.





Frontier Advisors

Level 17, 130 Lonsdale Street, Melbourne, Victoria 3000

Tel +61 3 8648 4300

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