

PRIVATE CREDIT: THE GOOD, THE BAD AND THE UGLY



Private credit is in the headlines. A number of funds have limited redemptions, and ASIC has flagged weaknesses in the local market. The result is widespread concern about all private credit funds, good and bad. So what separates the good from the bad and the plain ugly?

The growth of private credit over the past two decades was an intended outcome of post-financial crisis reforms, which aimed to shift lending away from banks and towards non-bank institutions. Its rising share of the financial system is therefore largely a desired outcome, not a cause for alarm.

But rapid growth invariably brings excesses, and private credit is no exception.

Australia's \$200 billion private credit sector is showing signs of stress amid a weakening property market and rising interest rates. Some of its biggest firms have limited redemptions, prompting the corporate regulator to warn that significant cracks are appearing.

The Reserve Bank of Australia is bracing for rising defaults and is concerned that concentrated loan books, particularly in property, would amplify any shock from the sector.

Globally, the collapses of subprime auto lender Tricolor and car parts company First Brands have prompted some of the biggest players to "gate" redemptions, refusing investor requests to withdraw money. Concern is also growing about offshore funds' exposure to artificial intelligence and software firms, which sold off heavily earlier this year.

JPMorgan Chase chief executive Jamie Dimon captured the mood: "when you see one cockroach, there are probably more".

ASIC has so far surveyed 28 private credit funds and identified several red flags. Only four published the interest rates or ranges charged to borrowers, fewer than half had detailed credit, impairment and default management policies, and most lacked adequate separation between those approving loans and those independently assessing their ongoing performance and value.

Investors are understandably growing wary. But not all private credit is bad: ASIC itself has said, “Private credit, if done well, is good for the economy and investors”¹. There is a good, a bad and an ugly in private credit, but they are not always easy to tell apart.

The Good

The “best” private credit investment depends on an investor’s goals, but senior secured direct lending is widely viewed as the most attractive core option. These loans are typically made to mid-market companies and secured against the borrower’s assets, giving investors priority in the capital structure and stronger downside protection.

Because banks have stepped back from middle-market lending, private lenders can negotiate favourable terms, including higher interest rates, covenants and collateral coverage.

Senior secured loans also tend to pay predictable, floating-rate income, which helps protect returns when interest rates rise. They are not risk-free – credit selection, sector exposure and manager quality all matter – but they offer a balanced combination of yield, security and resilience.

In short, the “good” is defensive, non-cyclical, diversified lending driven by disciplined credit selection, collateral coverage and capital preservation. For investors seeking stability with attractive risk-adjusted returns, it is the strongest foundation in private credit.

The Bad

Some private credit strategies are complex and demand serious due diligence, which most investors, including professional money managers, are not equipped to do.

These include covenant-lite loans, distressed lending, highly leveraged unitranche loans, and niche asset-backed loans secured against speculative assets, volatile cash flows or unproven technologies. Any of them can turn problematic if collateral values collapse or markets move unexpectedly.

Across all these categories, weak underwriting, limited transparency and misaligned incentives are the common threads that make them risky corners of private credit.

¹ ASIC media release 25-09MR The future of Australia’s public and private markets.

The Ugly

In Australia, real estate lending makes up 40–60 per cent of private credit and has been described as “the weakest link” in the sector, being vulnerable to inflation, cost escalation, project delays and interest rate rises. The collapse of property developer Bathla Group, which entered administration in August owing \$3 billion, brought these risks into sharp focus.

Information quality is crucial, for both regulators and investors. There is no getting around due diligence, particularly on a manager’s credit assessment skills, because that is fundamentally what you are investing in.

The key risks in any private credit investment, and particularly the ugly ones, are illiquidity and borrower concentration. These funds typically lend to small and mid-market companies that are more vulnerable in downturns, with opaque valuations, limited borrower disclosure and complex, layered fund structures.

Conclusion

Despite these risks, private credit continues to attract capital. The appeal is stable, high yields relative to public credit markets, plus diversification and the appearance of low volatility. But much of that stability comes from smoothed, “mark-to-model” valuations, which make portfolios look less volatile on paper even as underlying risks rise.

That stability may therefore be illusory. In the next major downturn, private credit funds could reveal much higher losses than expected, precisely because their risks and exposures are opaque.

Transparency is a key quality to look for in any managed investment, because it shows where and how your capital is invested. Across private credit, it varies widely between managers.

Separating good, bad and ugly managers takes time and skill, but yield offers a quick guide. A yield similar to an investment-grade bond fund suggests the “good” category. Higher yield, the attraction for many investors, means higher risk: the higher the yield, the further a fund is likely to sit towards “bad” and “ugly”.

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