Beyond traditional – Putting private credit in perspective

Recent headlines surrounding the collapse of Bathla, previously one of Sydney's largest residential homebuilders, have prompted understandable questions from investors about private credit. While such events attract significant attention, they also provide an opportunity to revisit a key investment principle: private credit was never designed to eliminate risk, but rather to compensate investors for assuming it in a considered and disciplined manner.

These developments warrant careful monitoring – we continue to engage closely with our fund managers to assess any implications for client portfolios. However, they should not automatically be viewed as evidence of widespread deterioration in underwriting standards across the Australian private credit market. The current environment remains challenging for borrowers, particularly property developers, who continue to contend with elevated interest rates, higher construction costs and uncertainty in housing markets. These conditions naturally increase the likelihood of financial stress, even among otherwise viable projects and developers.

This Wealth matters publication addresses three key considerations for private credit investors: credit risk, illiquidity risk and the role the asset class plays within portfolios. Recent events have reinforced the importance of manager selection in determining investor outcomes.

Private credit is likely to remain an area of heightened scrutiny from investors, regulators and the media. We welcome initiatives that improve transparency, governance and industry standards across the asset class. While recent events serve as a reminder of the challenges associated with lending, they do not change the role private credit can play within a well-diversified portfolio.

Credit risk – Borrower stress and defaults are a risk of lending

At its core, private credit is a form of lending. Investors provide capital to borrowers in exchange for returns – with funds typically targeting high single-digits to low double-digit returns depending on the level of risk assumed. Compared with cash and traditional fixed income investments, these higher returns are intended to compensate investors for accepting additional risks which can't be eliminated, including borrower default, reduced liquidity and the additional complexity associated with private lending.

Borrower stress and defaults are an unavoidable risk in all forms of lending. No matter how rigorous the underwriting process, lenders cannot completely prevent borrowers from experiencing financial difficulty. Economic conditions change, construction costs rise, projects are delayed and business plans do not always unfold as expected.

A borrower default does not necessarily translate into a permanent loss of investor capital. Experienced managers structure loans with multiple layers of protection, including first-ranking security, conservative loan-to-value ratios (LVRs), sponsor equity, pre-sales requirements and cross-collateralisation arrangements designed to protect lenders should a borrower encounter difficulties.

While no structure can eliminate the probability of loss, these protections are intended to improve recovery outcomes and reduce the likelihood of permanent capital loss.

The Bathla situation is one of the most closely watched private credit developments in Australia in recent years due to the scale of the exposure and the prominence of the borrower. However, it remains important to distinguish between a significant borrower-specific event and evidence of broader systemic underwriting weakness across the private credit market.

While losses may ultimately emerge for some lenders, many exposures are secured against underlying assets and structured with varying degrees of protection. Recovery outcomes will depend on the quality of those assets, security positions and restructuring processes.

Illiquidity risk – Illiquidity is a feature, not a flaw

Recent events have also drawn increased attention to redemption restrictions and liquidity management practices employed by some private credit funds.

Private credit is inherently an illiquid asset class. Unlike publicly traded shares or bonds, private loans are generally held until maturity and are not readily traded in public markets. Investors are compensated for accepting this reduced liquidity through an additional return premium, often referred to as the illiquidity premium.

Put simply, the ability to access capital at short notice and the ability to earn an illiquidity premium are often competing objectives. The appropriate balance depends on an investor's liquidity requirements, risk tolerance and return expectations.

The recent focus on redemption gates highlights the importance of aligning liquidity expectations with the nature of the underlying assets. During periods of market stress or heightened uncertainty, some funds may implement redemption gates, withdrawal queues or temporary restrictions on withdrawals, limiting the amount of capital that can be redeemed over a given period. While these measures can be frustrating for investors seeking access to capital, they are designed to balance the interests of both redeeming and remaining investors and avoid the need to sell assets prematurely or at discounted prices.

The use of redemption restrictions does not necessarily indicate an issue with the underlying loans. Rather, it reflects the reality that private credit is a long-term investment strategy and that liquidity terms should be consistent with the characteristics of the underlying assets.

The role in portfolios – Why Mutual Trust continues to invest in private credit

While recent headlines have focused on the risks associated with private credit, it is equally important to consider the role the asset class plays within diversified portfolios.

Many private credit investments are structured as senior secured loans, providing lenders with contractual claims over underlying assets and placing them higher in the capital structure than equity investors. While security does not eliminate the possibility of loss, it can provide greater protection and improve recovery outcomes in stressed situations.

Alongside this focus on capital preservation, private credit can offer attractive income generation, diversification away from traditional equity markets, and access to opportunities that are generally unavailable through public markets. Many loans are also floating-rate in nature, meaning income payments can adjust as interest rates change, helping to mitigate interest-rate risk relative to traditional fixed-rate bonds. The asset class has also historically delivered a more stable return profile than listed asset classes, although the underlying risks associated with lending remain.

For these reasons, we continue to view private credit as a valuable portfolio building block for suitable investors – the optimal allocation remains dependent on an investor's risk tolerance, liquidity requirements and performance objectives.

Manager selection matters

Private credit is not a homogenous asset class. Risks and potential rewards vary significantly across strategies and managers, with outcomes differing materially depending on underwriting standards, portfolio concentration, security structures, diversification and liquidity management practices.

For Mutual Trust, manager selection remains the most significant factor in determining investor outcomes. We partner with managers that demonstrate disciplined underwriting standards, rigorous credit assessment, conservative lending practices and proven workout experience across market cycles.

This reinforces the importance of ongoing due diligence and maintaining exposure to managers with a strong focus on capital preservation and risk management.

For a broader discussion of the benefits, risks and portfolio role of private credit, please refer to our previous Wealth matters articles:

- Beyond traditional: Spotlight on Private Credit
- Beyond traditional: Pulling Back the Curtain on Private Credit

Please reach out to your Mutual Trust Advisor with any questions.

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