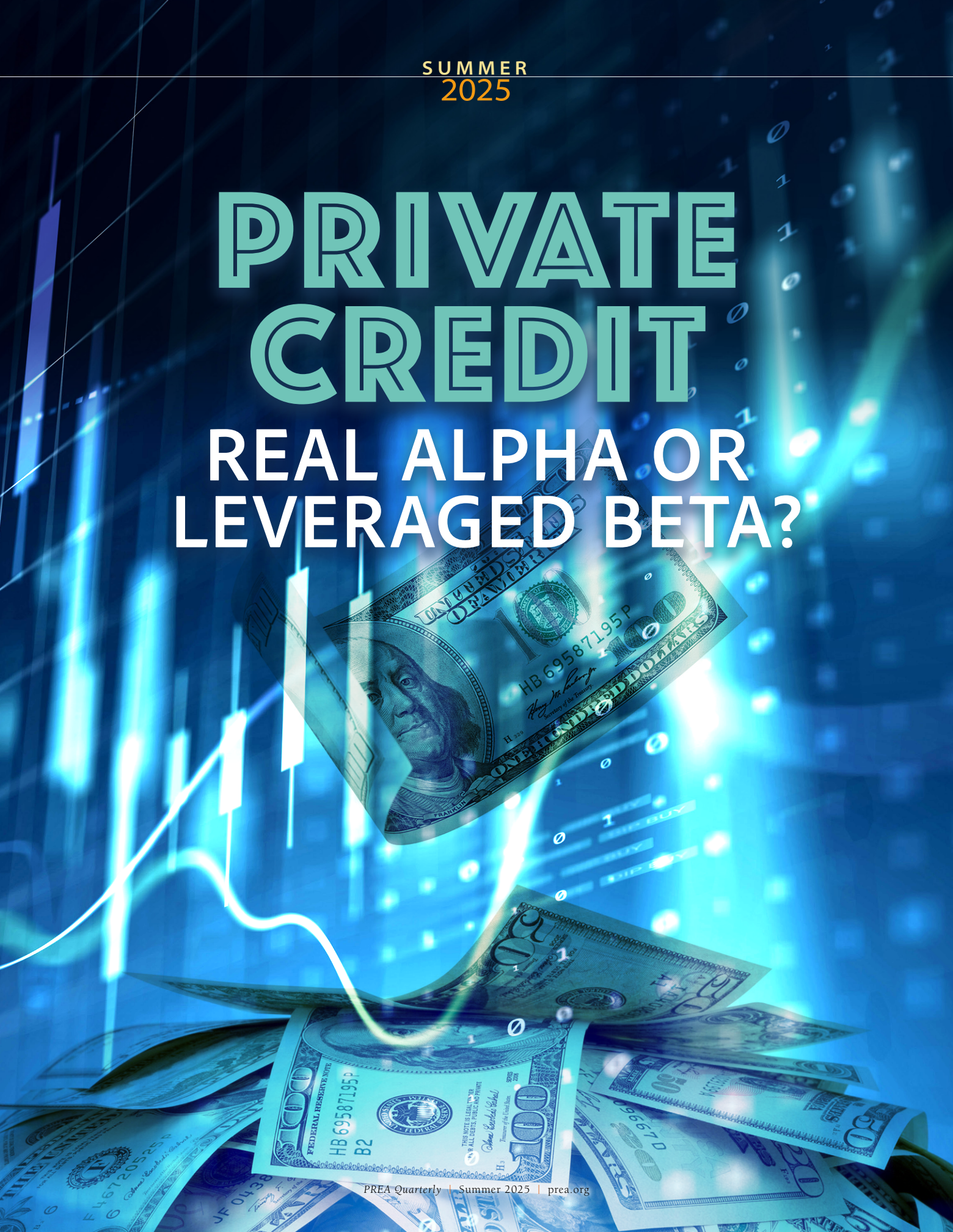


SUMMER  
2025

# PRIVATE CREDIT

## REAL ALPHA OR LEVERAGED BETA?





**Amachie Ackah**  
Clay Cove Capital, LLC



**Brian D. Eng**  
Clay Cove Capital, LLC



**Isaac Friedman-Heiman**  
Clay Cove Capital, LLC

The normalization of interest rates is exposing a fundamental truth about private credit markets: many of the risks investors think they are paid for are not the ones they bear. For 15 years, “equity-like returns with debt-like risk” wasn’t just marketing—it was reality. Private credit delivered consistent returns while avoiding the volatility of public markets, growing from \$46 billion in 2000 to \$1.7 trillion by 2023, with projections to grow to \$3 trillion by 2028 (Exhibit 1).

This extraordinary growth reflected genuine value creation. In the wake of the global financial crisis, private credit filled critical gaps left by retrenching banks. It provided not just capital, but certainty—the ability to execute complex transactions with customized terms and reliable timing. But success at this scale inevitably transforms the nature of any opportunity. What began as a specialized solution for unbankable but creditworthy borrowers has evolved into a vast ecosystem in which thousands of funds deploy hundreds of billions of dollars annually.

The question is no longer whether private credit can generate attractive returns—history has answered that decisively. The question is whether the returns being generated today come from the same fundamental sources as those historical successes.

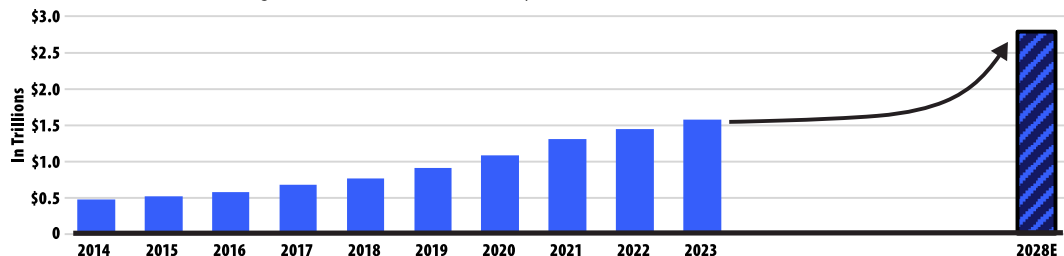
### The Evolution of a Financial Product

Private credit’s track record validated the original model. During the zero-interest-rate era, private credit funds routinely generated returns of 15% or higher with minimal volatility. But here’s the critical question: were those returns genuine alpha from superior credit selection and structuring or simply leveraged beta—the amplified returns from taking credit risks during the longest economic expansion in modern history?

To understand leveraged beta, consider this: when a fund borrows at 3% to lend at 8%, it’s not just capturing the credit spread but amplifying it through leverage. In a benign credit environment with minimal defaults, this looks like skill. But it’s just magnified exposure to the credit cycle—beta multiplied by leverage. The distinction matters because leveraged beta masquerades as alpha during good times. Only when the cycle turns do observers discover who’s been swimming naked.

### Exhibit 1: Growth of Global Private Credit Assets Under Management

Private credit assets under management (AUM) will hit \$3 trillion by 2028.

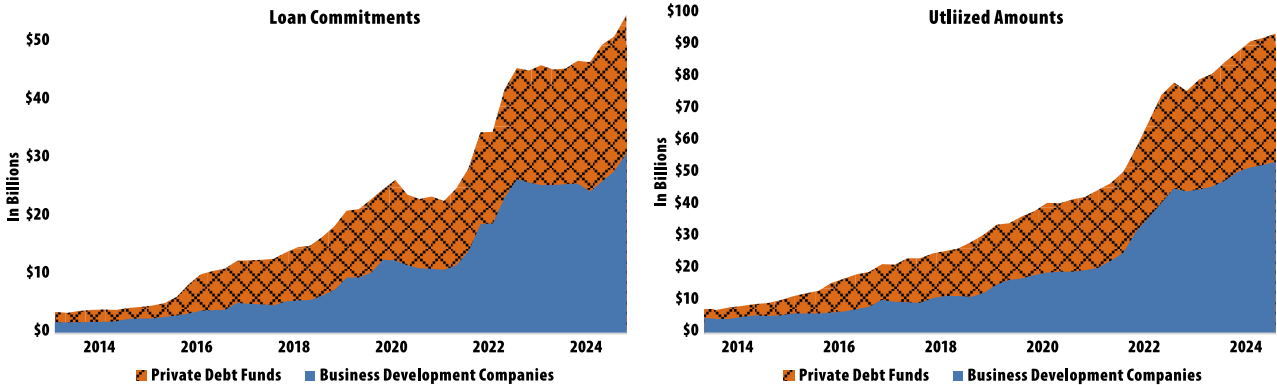


Sources: Preqin, Moody’s Ratings

Notes: Clay Cove’s estimate uses Preqin’s historical private debt fund AUM figures, which are not inclusive of all private credit AUM. Data do not include asset-based financing, real estate and infrastructure private credit assets, assets in nonfund structures, and leverage on these funds.

**Exhibit 2: Bank Exposure to Private Credit Funds**

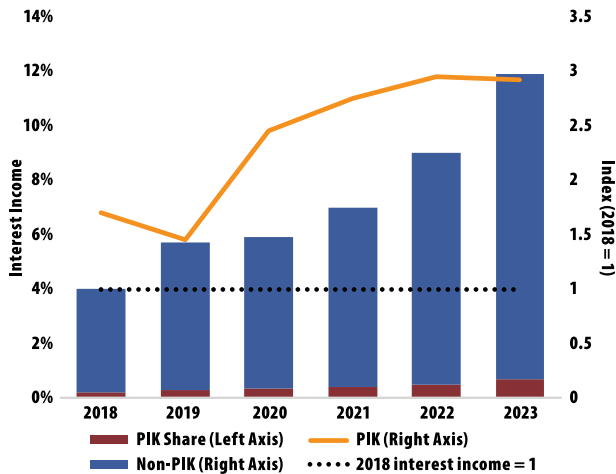
Direct bank commitments grew from \$8 billion in 2013 to \$95 billion in 2024; total exposure is estimated at \$1.2 trillion.



Source: Federal Reserve, “Bank Lending to Private Credit”

**Exhibit 3: BDC Interest Income and PIK Share**

PIK interest has doubled since 2019, reaching ~10%–12% of BDC interest income by 2023.



Source: IMF Global Financial Stability Report, April 2024

This question becomes more pressing when examining real versus nominal returns. During the zero-rate era, 15% nominal returns meant 13%–14% real returns. Today, private credit offers 10%–12% nominal returns against a 4.5% risk-free rate—a dramatic compression in both absolute and risk-adjusted terms (Exhibit 2).

Despite private credit’s promise to bypass traditional banks entirely, the opposite has occurred. When including credit lines that banks extend to these funds,

loans secured by fund assets, and temporary financing, total bank exposures reached \$1.2 trillion as of March 2025. These interconnections reveal how private credit, rather than replacing bank lending, has become deeply intertwined with it.

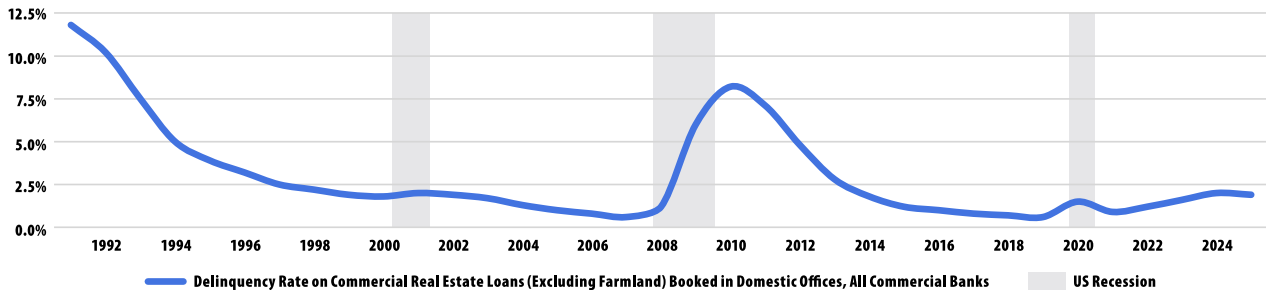
**The Deployment Trap and Adverse Selection**

The pattern is familiar to any student of financial history. Today’s private credit industry exhibits all the warning signs: complex financial products reduced to simple slogans, disciplined underwriting giving way to deployment pressure, and the skill sets required to manage inevitable restructurings becoming atrophied.

Evidence of deteriorating standards is mounting. Roughly 90% of leveraged loans issued today are “covenant-lite.” The share of loans undergoing amendments or extensions rose from 8% to nearly 12% between 2023 and 2024. Payment-in-kind (PIK) interest, in which borrowers defer cash payments by adding to principal, now exceeds 10% of income at several top business development companies (BDCs). Meanwhile, the International Monetary Fund warns that more than 40% of borrowers showed negative free cash flow at year-end 2024 (Exhibit 3).

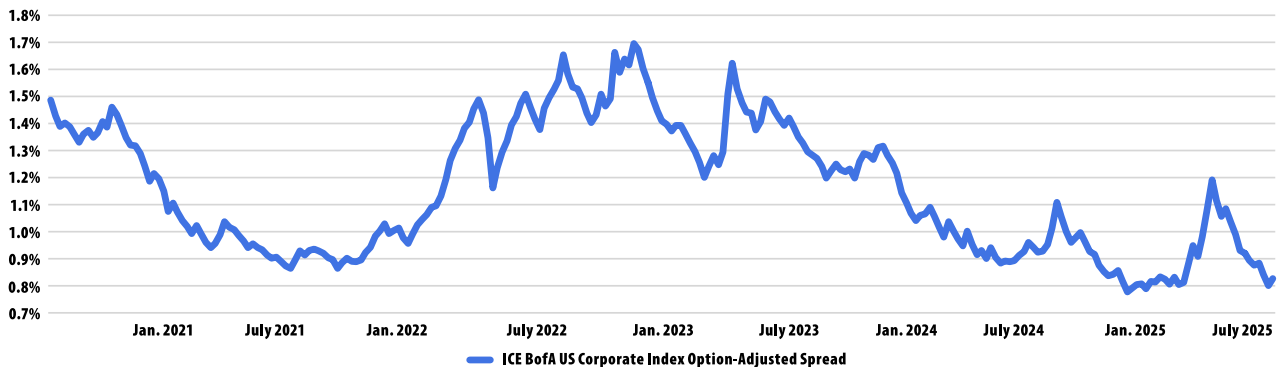
Investment-grade corporate spreads have compressed to near-historical lows of under 90 basis points (bps), pushing yield-seeking investors toward real estate

**Exhibit 4: Commercial Real Estate Loan Delinquency Rate**



Source: Federal Reserve Bank of St. Louis (FRED); as of 1Q2025

**Exhibit 5: US Corporate Investment-Grade Option-Adjusted Spread**



Source: Federal Reserve Bank of St. Louis (FRED)

credit despite its operational complexities. Private credit historically commanded more than 1,000 bps over risk-free rates during periods of genuine capital scarcity. Today’s 550 bp–750 bp spreads reflect not just increased competition but a basic mispricing of risk.

The competitive dynamics have fundamentally shifted. Banks and insurance companies cherry-pick the best deals—trophy properties, investment-grade corporates, high-quality infrastructure. Private credit gets what’s left: transitional properties, highly leveraged sponsors, and sectors facing structural headwinds—adverse selection on an industrial scale.

### The Illusion of Simplicity in Real Estate

Nowhere is this transformation more apparent than in real estate, where private credit has become the marginal price setter for an entire asset class. Real estate debt funds now capture 24.3% of all real estate fundraising,

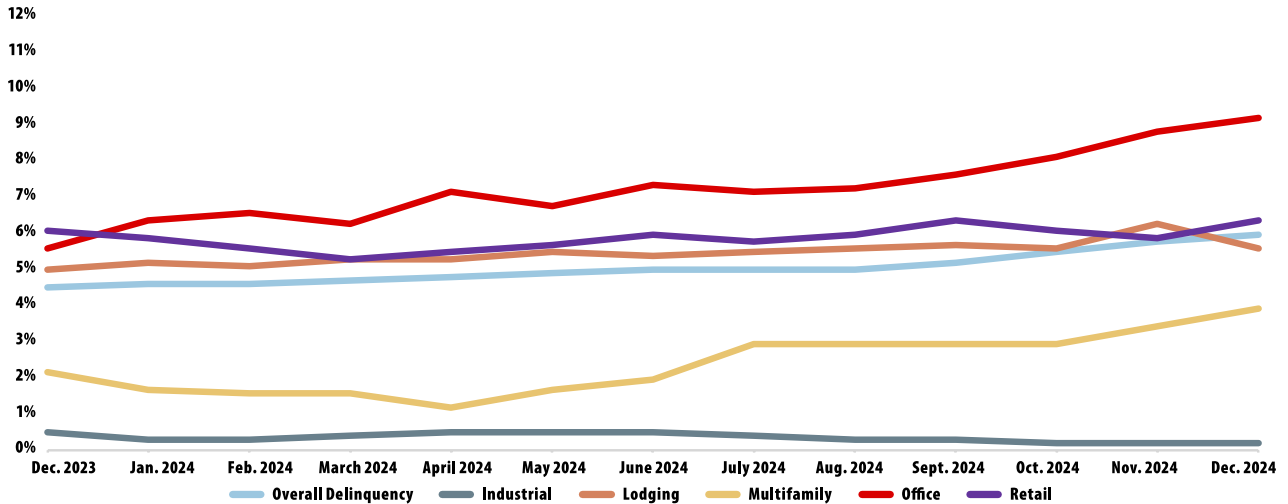
drawn by the apparent simplicity of lending against “hard assets.”

But what does hard assets mean when office buildings face structural obsolescence from remote work, retail properties require complete repositioning for e-commerce, or multifamily assets need active revenue management amid supply shocks? The building may be tangible, but its value increasingly depends on intangible factors: tenant relationships, technology integration, and operational execution—capabilities that traditional credit analysis often fails to capture (Exhibit 4).

### The Wall of Maturities Ahead

The scale of the commercial real estate refinancing challenge is staggering. An estimated \$950 billion in US commercial mortgages matured in 2024, with \$1.7 trillion set to mature by year-end 2026. Although total US commercial real estate debt from all nonbank

**Exhibit 6: CMBS Delinquency Rates by Major Property Types**



**Source:** Trepp CMBS Delinquency Report, December 2024

sources totals roughly \$4.8 trillion, private real estate debt funds specifically manage about \$250 billion—a subset focused on the most complex situations (Exhibit 5).

Consider the current state of distress. Office delinquency reached 7.2% by mid-2024, with \$20.4 billion in special servicing. Commercial mortgage-backed securities (CMBS) office payoffs hit less than 40% on time in late 2024, with modification rates across CMBS pools nearing 15%. These aren't temporary accommodations—they represent systemic challenges that extend-and-pretend strategies can defer but not resolve (Exhibit 6).

Office properties face an existential crisis, with values collapsed 20%–50% from their peak. The multifamily sector confronts a supply shock meeting a rate reset, with a record 580,000 apartment units delivered in 2024 just as floating-rate borrowers see debt service costs double. Even industrial properties, the relative safe haven, face refinancing challenges on loans originated at peak 2021 valuations.

These statistics translate into operational realities that pure financial strategies cannot address. Private real estate debt funds increasingly discover they must be prepared to “own the keys” to protect principal.

Foreclosing on a half-empty central business district office tower means confronting capital needs of \$50–\$150 per square foot in re-tenanting costs and 18–24 months to stabilize occupancy. The lender becomes an asset operator by necessity, not choice—doing equity-like work for debt-level returns.

### The Restructuring Cycle Ahead

The transformation of private credit from niche solution to major asset class has created a fundamental disconnect between perception and reality. Where genuine alpha once existed—through specialized expertise and patient capital filling real market gaps—the industry increasingly generates returns through leverage and systematic market exposure.

The math is unforgiving. When 40% of borrowers show negative free cash flow, when PIK interest exceeds 10% of income at major funds, when modification rates approach 15%—these aren't temporary disruptions. They're structural failures masked by accounting flexibility. Real estate strips away these masks because buildings demand real money: property taxes must be paid, HVAC systems must function, tenants must receive services. It's not possible to “PIK” a roof replacement.



A collision of harsh realities lies ahead for 2026–2027:

- **The refinancing collision:** \$1.7 trillion in maturities meets a \$150 billion annual funding gap. Properties that barely have cash flow at today’s rates won’t qualify for tomorrow’s loans.
- **The PIK conversion moment:** As rates stabilize, funds must either convert PIK interest to cash or acknowledge losses.
- **The vintage reckoning:** 2021–2022 originations at peak valuations face their first real test. Loans made assuming 3% rates meet 7% reality.
- **The systemic transmission:** Bank warehouse lines ensure private losses become public concerns. The \$1.2 trillion in interconnections means private credit’s problems won’t stay private.

Private credit remains a valuable tool when properly deployed—matching patient capital with complex situations, filling genuine market gaps. The problem arises when investors treat private credit as insulated from the underlying dynamics of asset performance

and refinancing risk. What appears to be stable yield from senior secured positions is actually a leveraged bet on continued credit availability and asset values that may no longer reflect fundamental demand.

The next era of private credit will separate those who understand they’re in the business of operational value creation from those who believed they were simply collecting enhanced yield. In real estate particularly, that distinction will determine not just returns, but survival. Those who mistake leveraged beta for safety are about to learn that “hard assets” can bleed very real cash. ■

*Amachie Ackah is Cofounder, Managing Partner, and Chief Investment Officer; Brian D. Eng is Cofounder, Managing Partner, and Chief Compliance Officer; and Isaac Friedman-Heiman is Senior Advisor at Clay Cove Capital, LLC.*