

Private Credit Realities: Beyond High Returns & Low Volatility

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Go beyond the sales pitch and examine the true risks of private credit. Learn how to evaluate loan structures, interest rates, and the borrower's financial health.

By Brian Regan

Private credit is a popular topic in the RIA channel right now. The sell praises high returns and the mirage of minimal volatility. My goal with this article is to give readers a depiction of how private credit loans work in real life rather than the picture that is painted for them while looking at recent historical returns. Letting the reader understand how this works operationally can hopefully help people understand the real risk they are taking and make more informed decisions.

The Business

You have a friend, Bobby. Bobby is a natural entrepreneur. After a few years of saving money, Bobby decides it is time to strike out on his own. He uses those savings to establish a legal entity, develop a prototype, find a manufacturer overseas, a logistics company and start to test the market. Bobby's original project is a children's toy. It's simple and inexpensive like Pogs or Legos. He attends the toy convention in January and comes home excited that he has some real interest from big box retailers.

Year 1

Bobby wants to have product available to ship when orders come in. The manufacturer needs 30 days lead time, it takes 30 days to ship and orders from Big Box retailers come in for the Christmas season in July. Bobby estimates that he'll need \$750,000 for the season's inventory build and needs to start no later than May 1. Bobby gets a business loan and uses his home as collateral to finance the inventory build at 7% annual interest from a major bank.

In July, the orders come in. The retailers only want to pay a 10% margin and only want

\$700,000 worth of product.

Christmas comes and goes. The retailers eventually sell through the product with a good amount of success and limited discounting. The retailers have 60 day terms after the December 1 delivery, so Bobby does not get paid until February. Bobby made \$70,000 in gross profit. He still has \$50,000 worth of inventory. He feels pretty good about himself after the first year of business.

However, Bobby accrued and needed to pay more than \$39,000 in interest expense in the nine months from build to collection. To finance the interest expense, Bobby went back to the bank and got a revolver loan that is collateralized by a combination of the inventory and receivables at a floating rate that starts at 10%.

Year 2

January comes and Bobby again attends the toy convention. The retailers are excited to see Bobby and tell him they expect to buy more than the prior year since it was a successful first year. They tell Bobby they would be even more optimistic if he developed another SKU (stock keeping unit) and did some advertising. Excited about the feedback, Bobby gets to work.

After paying down the interest expense (from two different loans) with the proceeds from the prior year and unloading the excess inventory at cost during the Easter season, Bobby takes the \$30,000 leftover to pay himself and live. Bobby estimates he needs \$1 million for the next year to finance an \$800,000 build, \$100,000 in new development, and \$100,000 in advertising. The bank he is working with is happy with Bobby. He has paid his interest and principal on both loans. They agree to finance 70% of the inventory build (70% of \$800,000 = \$560,000) at 10%. He needs to finance the remaining \$440,000 that the bank will not finance. Bobby does not want to risk his home again and looks for a private creditor.

Bobby, before searching for private credit, does not have any petty cash. He will accrue \$42,000 in interest costs on the nine-month lead time on the loan with the bank before receiving cash. Bobby does not have any hard orders, but he does have soft interest. He is at risk of interest rates moving and not having good hard orders as he hopes.

Would you lend to Bobby?

Despite having a decent first year of business, Bobby still needs a significant amount of financing (\$440,000 for advertising and new SKU) + \$42,000 (interest expense). If you

were the private creditor, what would you charge and how would you structure it? Would you consider this direct lending as low risk or high risk?

For me, this is an extremely risky proposition. I would not finance additional build from the prior year's orders (meaning I'd only lend $\$700,000 - \$560,000 = \$140,000$). I would not want to take the risk that the soft estimates became additional orders. I would not fund new advertising or the buildout of a new SKU because to be paid I would need a significant increase in margins without a track record of success. I would require up front origination fees and a very large interest rate. Bobby's business situation would be bleak with this new level of debt, and he would likely need to come up with some new equity capital.

You can see how this could be profitable for a lender. The lender is in the driver's seat to dictate terms because the business needs the money to survive and grow. You can also see easily that if the toy is upended in a competitive market that everyone loses. Finally, you can see how the holes in the boat can be endlessly plugged by more debt if it is easily available. Once additional debt becomes less available, the boat quickly sinks into bankruptcy.

Credit Cycle

Credit growth is a two-edged sword. Bobby's company would not exist at all without credit from the bank and it would not be able to grow without private credit. If he had more access to equity capital this may all be more tenable. Over time, the risk can also snowball with one creditor bailing out another or an equity investor taking down a large part of Bobby's business to finance the growing debt. The debt can amass to the point where failure is inevitable without flawless business execution or share dilution, and defaults occur. This process is known as a credit cycle.

As an investor, if it seems like private credit providers have an insatiable desire to raise capital, you may want to ask yourself why and if it is indicative of where we are in the credit cycle. You may want to know if your lending is collateralized or where it fits in the capital structure. You may want to know what industry the loans are funding or what projects. If risky loan rates are historically low (as they are today), you may ask if you are being compensated for all this risk. The myriads of issues are why private credit is usually a hands-on approach with professionals with high fees. If you're a cynic, you might think that the high fees accelerate the push for more risky credit availability, and I would not disagree.

The bottom line is that credit is the lifeblood of the economy, but extension of credit irresponsibly can sow the seeds of disaster. Private credit is hot right now, historic returns may look attractive and good managers may continue to do well but non-collateralized,

floating rate, low spread debt to middle market companies represent a significant level of risk that may not be prudent for you or your client.

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