

METRICS

White Paper

# Understanding private debt investing.

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NOVEMBER 2024

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# Introduction

In a little over a decade, Australian private debt has developed into an accepted asset class which plays an important role in the investment strategies used by both institutional and individual investors.

The evolution of the local market is part of a worldwide trend that continues to gain momentum and will likely result in more people holding private debt alongside traditional equity and fixed income assets, which have formed the mainstay of portfolios in the past.

Research firm Preqin has forecast that assets under management in global private debt funds will reach US\$2.3 trillion by the end of 2027, up from US\$1.5 trillion in 2021<sup>1</sup>.

This whitepaper seeks to demystify this rising asset class by explaining the key characteristics that enable it to provide attractive risk-adjusted returns and low capital volatility.

Private debt is one of the oldest forms of finance and when matched with modern legal safeguards – particularly those that apply in Australia – it can offer a compelling investment proposition to either defensive investors seeking an alternative to traditional fixed income or others seeking an alternative to equities.

In both cases, the key to a successful investment is the selection of a fund manager with the prerequisite skills to originate loan transactions, properly assess the credit risk of borrowers and construct diversified portfolios.

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<sup>1</sup> Preqin Pro, as at December 2022.

# What is private debt?

Private debt funds raise money from investors and lend it directly to medium-to-large-sized companies in a similar manner to banks.

The global financial crisis (GFC) and the COVID pandemic created an environment that allowed the Australian private debt market to expand.

Following the GFC, regulatory changes required banks to adopt more conservative lending practices and hold increased capital against certain types of loan assets. This restriction on business credit availability compelled borrowers to seek alternative funding sources.

More recently, in response to the economic fallout from COVID, central banks reduced interest rates to near zero to stimulate growth. This low-interest-rate environment prompted investors to look beyond traditional investments, such as bonds and term deposits, to generate income.

Private debt largely filled these needs and the global market has since grown rapidly, with an increasing number of fund managers offering access to it.

As a result of this evolution, superannuation funds, insurance companies, charities, universities and family offices have increasingly become long-term investors in private debt because of the attractive and stable returns the asset class can offer.

Furthermore, the advent of both unlisted and listed funds has now made private debt equally accessible to individual investors.

Consequently, private debt is quickly becoming a mainstream option that marries the needs of Australian companies seeking capital with investor demand for income and capital preservation.

## Who are the borrowers?

Most private debt managers focus on providing loans directly to medium-to-large-sized companies or financing projects in areas such as commercial real estate (CRE) and infrastructure.

Australia's corporate loan markets can be split broadly into five sectors. At various times, each of these segments may offer better risk-adjusted returns and therefore better lending opportunities than others.

- 1. Corporate loans:** This is the most common form of loan product for companies, including large ASX-listed entities. While this type of lending is dominated by banks, it also provides opportunities for private debt managers of scale. Borrowers in this sector are diversified across all industry groups in the economy.
- 2. Leveraged and acquisition loans:** These loans can take two generic forms depending on whether the acquirer of the company is an existing business with its own cash flow and assets, or a special purpose vehicle (SPV) created and capitalised by a sponsor for the purpose of an acquisition. These facilities are structured around debt serviceability and security.

### 3. Project and infrastructure loans:

These loans can be structured for greenfield projects that comprise two elements: an initial cash-spend construction phase; and then a cash-generating operations phase upon completion. Loans can also be structured for projects that are already built – or ‘brownfield’ projects. Funding of public private partnerships has been an important contributor to this segment in recent years. Types of borrowers in this sector include transport, infrastructure and services.

**4. Commercial real estate loans:** These loans can be for different stages of a real estate project – including land purchase, pre-construction activities, construction, residual stock, or investment. Typical borrowers include companies involved in the development, ownership or management of industrial, residential, office or retail property.

**5. Structured finance:** These are typically notes issued by a SPV as part of a layered capital structure, also referred to as securitisation, to fund the lending activities of a non-bank financial institution. These notes give the lender the right to cashflow from a large, diversified underlying pool of secured loans, often comprised of residential mortgages (RMBS), automotive financing (ABS) or small-ticket commercial mortgages (CMBS).

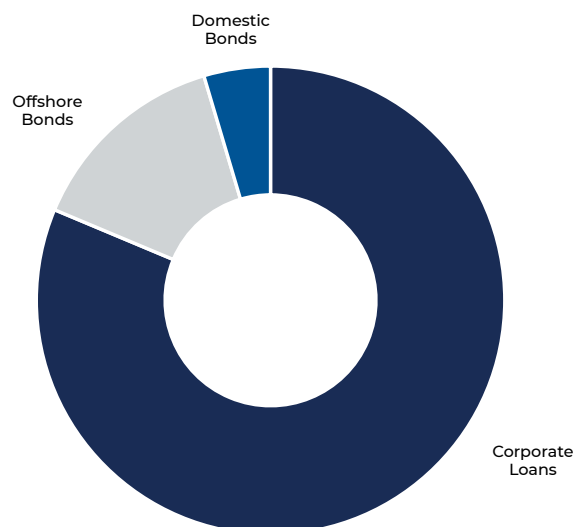
## Why invest in private debt

Australian private debt is among the few asset classes that aims to offer both reduced capital volatility and attractive risk-adjusted returns.

It has a low correlation with growth assets such as equities and property, as well as other fixed income products such as bonds.

As depicted in Figure 1, the size of the market also means it offers a substantial opportunity set and significantly greater diversification than an investor could achieve by investing in corporate bonds.

Figure 1. Australian corporate loans vs corporate bonds<sup>2</sup>



## Regular income

Private debt can provide regular income, even during periods of economic slowdown.

Interest and fee payments are received from borrowers at specified intervals under binding terms of their debt contracts. A floating base rate, with additional credit margin, means total interest income typically moves in line with the Reserve Bank of Australia (RBA) cash rate.

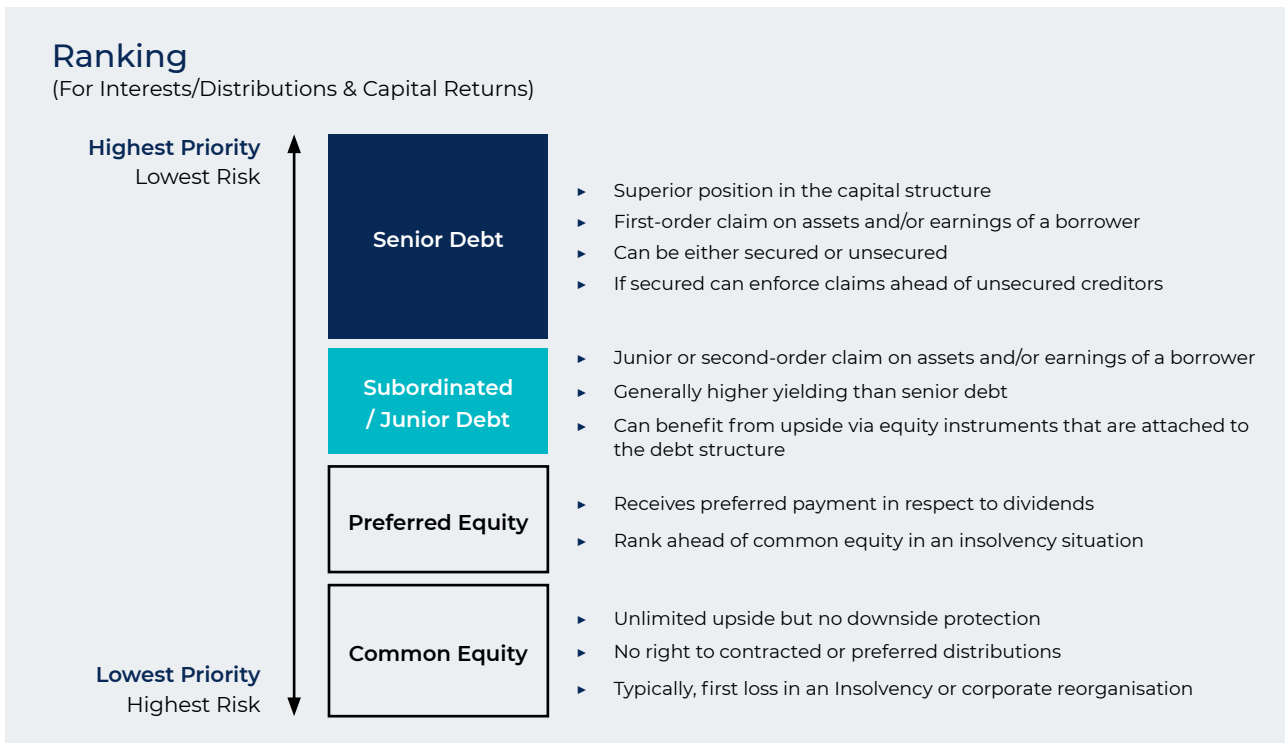
This contrasts with dividends that are paid to equity holders at a company's discretion and are subordinate to the payments to debt providers. Even when equity markets were at their most turbulent in early 2020, and many companies were suspending or reducing dividends, well-managed private debt funds continued to deliver consistent monthly income for investors.

More conservative funds can deliver a return of around 6 per cent to 9 per cent, an attractive alternative to low yielding corporate bonds, hybrids, government bonds or even cash deposits. A higher yielding fund can deliver a cash distribution of around 10 per cent to 13 per cent, a favourable alternative to investing in equities for income<sup>3</sup>.

<sup>2</sup> Source: ABS Australian National Accounts: Finance and Wealth – Financial Assets and liabilities of Non-Financial Corporations. Total short term and long-term loans and placements (A\$1,268bn), bonds issued offshore (A\$219bn), and bonds issued in Australia (A\$71bn) as at 31 March 2024.

<sup>3</sup> Metrics Credit Partners funds.

Figure 2. Senior debt position in the capital structure



### Low capital volatility

Another key attraction of the asset class is that it aims to provide capital stability throughout the economic cycle.

This is an advantage in an environment where fixed income investments don't always deliver the safe haven and downside protection they once did. Fixed rate bonds don't always provide stability as equities fall – as was demonstrated in 2022 – so private debt provides an alternative ballast for portfolios.

The ability of private debt to provide portfolio stability is driven by several factors.

Firstly, corporate debt is a lower risk investment than equity because Australian corporate insolvency law gives priority to the interests of creditors in claims over the assets of a business.

Secondly, a skilled lender/private debt manager seeks to negotiate appropriate terms and conditions, controls, reporting

obligations, covenants, and security with borrowers to mitigate against any potential risk of loss.

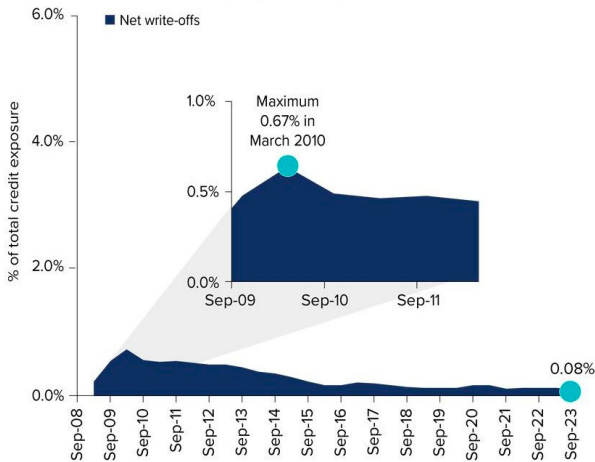
Loan security provided by borrowers serves to mitigate the risk of capital loss by giving the lender negotiating leverage and a means of protecting and recovering value if necessary.

Finally, the Australian corporate loan market has historically recorded low loss rates, even in times of market disruption such as the GFC. Net write-offs recorded by Australia's major banks have averaged approximately 0.25 per cent per annum since March 2009, peaking at approximately 0.68 per cent in 2010, before falling to 0.08 per cent per annum for the year ended 30 September 2023<sup>4</sup>.

If a default does occur, it does not necessarily lead to a credit loss due to the tight controls afforded to Australian lenders and the loan security typically provided by borrowers.

<sup>4</sup> Major Bank APS 330 reporting. Past performance is not a reliable indicator of future performance.

**Figure 3. Major banks' historical net write-offs as at 30 September 2023<sup>4</sup>**



### Protection from inflation

Inflation poses a threat to investors because it chips away at purchasing power as well as savings and investment returns.

Private debt can offer protection against inflation because returns come from interest that is generally charged as floating rate. The interest on the majority of Australian corporate loans is structured as a credit margin over the benchmark Bank Bill Swap Rate (BBSW), which is correlated with the RBA official cash rate. As the RBA lifts the cash rate, the BBSW rises too. This tends to insulate investors from rising inflation.

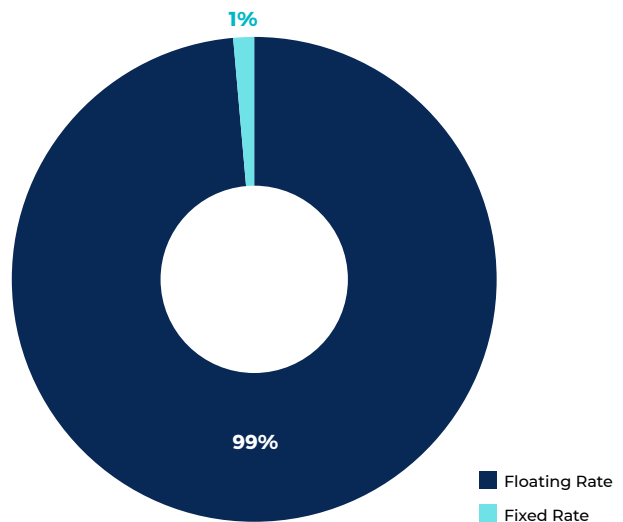
The BBSW is essentially the rate at which Australia's banks are willing to lend short-term money to other banks. It also reflects not only the current level of the RBA cash rate but also the expected level at which it will be over time.

In this way, returns on corporate loans keep pace with inflation, helping investors to maintain their purchasing power even as prices of goods and services rise.

By contrast, inflation can be particularly damaging to returns on investments such as fixed rate bonds. This is because the interest rate on these investments is fixed until maturity, so investors risk missing out on the income boost in a rising interest rate environment. If inflation concerns push up market interest rates, the capital value of the bonds in an investment portfolio can also decline because the present value of those fixed interest payments decline.

Equity markets can also be more volatile during inflationary periods, particularly as higher interest rates erode the value of future cash flow.

**Figure 4. Floating rate vs fixed rate split in a typical Australian private debt portfolio<sup>5</sup>**



<sup>5</sup> Metrics Credit Partners. This chart uses the MCP Wholesale Investments Trust as an example of a portfolio of Australian private debt. As at 30 November 2024, the Trust contains a diversified portfolio of 321 loans.



## ESG matters

Environmental, social and governance (ESG) principles can be integrated into a private debt fund in a similar manner to other asset classes.

In fact, private debt funds can have several key advantages over both equities and bond funds when it comes to influencing the development and implementation of a company's ESG commitments.

The chief advantage is the close relationship that private debt managers maintain with borrowers, as it allows them to directly engage with company management. A private debt manager is likely to be one of only a handful of lenders, sometimes the only lender, involved in a loan transaction. This may grant the manager leverage to influence a company's activities and operations.

Ongoing dialogue positions private debt managers well to assess the unique ESG risks and opportunities of their portfolio, and to engage with companies to seek positive sustainability outcomes. By contrast, a common approach in public markets may rely on purchased data or an opaque third party ESG assessment process to assess ESG risk.

When it comes to influence, even large equity funds often hold less than 5 per cent of the shares in any one listed company, and therefore are entitled to only a small proportion of the votes at an annual general meeting where key decisions are made.

The ESG engagement process with borrowers begins with initial contact and continues over the life of a loan to allow lenders to remain abreast of a company's progress against ESG related issues it faces.

Leading private debt funds apply robust ESG assessment processes and use it to drive positive outcomes across their portfolios.

## Risk of investing in private debt

Investing in private debt funds carries two principal risks – credit risk and liquidity risk.

Credit risk is the potential loss of fund capital due to a borrower's failure to repay loan obligations on a timely basis. It is created each time a loan or note commitment with a borrower is entered.

### Competent fund managers mitigate credit loss through:

- ▶ **Relationship:** Unlike the publicly traded bond market, private lenders have direct access to company management and owners that gives them a better understanding of a business.
- ▶ **Covenants:** Lenders can negotiate tailored covenants that require borrowers to operate within agreed constraints.
- ▶ **Loan security:** If a secured loan defaults, a lender can recover amounts owing ahead of other unsecured creditors and equity. Australia's corporate insolvency legal regime is protective of the rights of lenders.
- ▶ **Credit risk assessment:** A lender should ensure it is comfortable with all aspects of a borrower's business before providing a loan and should also conduct ongoing credit risk assessment.
- ▶ **Diversification:** Private debt managers aim to construct portfolios that are diversified by borrower, industry and credit quality.

Liquidity risk is the risk that an investor will not be able to redeem capital when desired. This is the same risk that applies to all managed funds, regardless of the asset class.

As private loans are not traded on public exchanges, liquidity is primarily derived from the staggered maturity of the underlying loan assets in a fund. If liquidity is required, a seasoned well-diversified portfolio will constantly pay principal and interest providing liquidity for investors.

Other risks are noted in the product disclosure statements for private debt funds.

### Where private debt sits in an investment portfolio

Private debt can play two very different roles in a diversified portfolio depending on the risk appetite and personal objectives of individual investors.

Funds which hold relatively low risk positions in senior secured or investment grade debt, and hence generate lower yields, may be suitable for defensive investors seeking an alternative to traditional bonds in a portfolio.

This style of conservative investment may have particular appeal in a rising rate environment as fixed rate bonds typically incur losses as interest rates move higher.

Funds which provide exposure to sub-investment grade debt or alternative parts of the capital structure – such as mezzanine or subordinated debt – could replace part of an investor's allocation to equities.



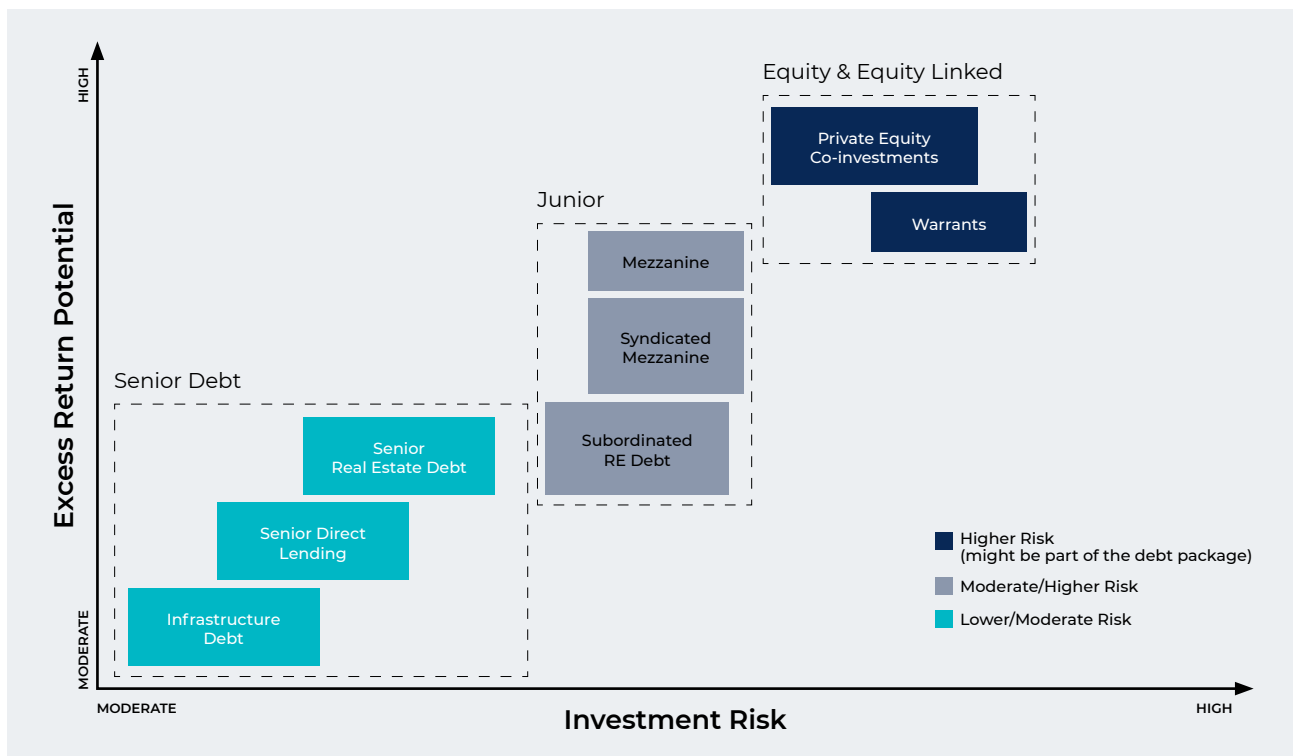
This type of private debt produces similar income to equities, but carries less risk due to its position in the capital structure. It can appeal to people who are uncomfortable with the volatility of the share market by offering a source of more predictable returns.

There has been a distinct shift in Australian investors' preference for private debt as the local industry has matured.

A decade ago, when the sector was in its infancy and understanding of private debt was limited, investors tended to prefer more conservative strategies with a focus on higher investment grade strategies.

Today, a broad cross section of investors has a better grasp of the benefits of the asset class and are increasingly adding higher-risk debt to their portfolios too.

Figure 5. Risk/Return spectrum of multi-asset credit.



## How to access the market

One of the best ways for investors to access corporate loans is through a low-cost diversified fund.

A well-managed fund reduces risk by investing in a range of sectors, loan types and borrowers with differing credit quality and maturity profiles.

Both listed and unlisted products are on offer. Listed funds offer daily liquidity via on-market trading on the ASX but are exposed to market volatility. Unlisted funds, on the other hand, are not exposed to the daily volatility of the share market but may only allow monthly, or quarterly, redemptions, or redemption via asset run off (as loans in the portfolio are repaid).

It is important to invest with a manager who has the necessary skills and experience to take the steps needed to preserve investor capital and negotiate appropriate pricing with the borrower to deliver optimal returns for investors.

### The key considerations when choosing a private debt manager include:

- ▶ **Size and scale:** Managers need a sizeable team, breadth of market coverage and borrower relationships to achieve proper diversification in private debt portfolios. A larger portfolio of loans, where each exposure represents a small percentage of the total, provides cover against any one loan having an outsized impact on the overall return to investors. The ability to lend larger sums also provides greater negotiating power in relation to loan terms and conditions.
- ▶ **Origination capability:** Check the manager has an in-house origination team to cultivate direct relationships with borrowers to directly negotiate loan terms and conditions.
- ▶ **Risk management capability:** A strong focus on risk management and experience in loan restructuring in the event of a default is essential to preserve investor capital.
- ▶ **Track record of performance:** Seek evidence that a manager has delivered capital stability and regular income payments to investors. It should also be able to demonstrate that it has met its stated investment targets over time.
- ▶ **Diversification:** Managers should maintain diversified portfolios to help spread risk across sectors. Investors should look for portfolios that are diversified across borrowers and ensure the exposure to any individual borrower does not expose their capital to inappropriate concentration of credit risk.

## Why Metrics Credit Partners?

Metrics is a leading Australian non-bank corporate lender and alternative asset manager with in approximately \$21 billion<sup>6</sup> in assets under management, attracting capital from institutions, financial advisors and individuals. It launched its first wholesale fund in 2013 and later pioneered public market access to private debt in Australia.

Its retail products include the Metrics Master Income Trust (ASX:MXT) Metrics Income Opportunities Trust (ASX: MOT) and the Metrics Real Estate Multi-Strategy Fund (ASX: MRE) which are listed on the ASX. It also offers an unlisted retail product – the Metrics Direct Income Fund – and a number of wholesale funds.

Metrics' 11-year track record of performance and capital preservation<sup>7</sup> is underpinned by a team of more than 160 investment professionals. It has completed more than A\$32 billion in total financing since inception via approximately 1,125 individual loan transactions.<sup>8</sup>

As a responsible investor, Metrics integrates the consideration of ESG issues into its investment process. It does not think that responsible investment requires any sacrifice of investment returns. In fact, Metrics believes entities that do not consider ESG issues present a higher risk to investors and are more likely to negatively impact long-term, risk-adjusted returns.

Through its dedicated Sustainable Finance team, Metrics is an active member of leading industry initiatives focussed on sustainability, including the Principles for Responsible Investment, UN Global Compact Network, Australian Sustainable Finance Institute, Investor Group on Climate Change and Responsible Investment Association of Australasia. As an investor signatory to the Net Zero Asset Managers initiative, Metrics has set science-based targets in relation to both its operational and financed emissions.

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<sup>6</sup> As at November 2024.

<sup>7</sup> Past performance is not a reliable indicator of future performance.

<sup>8</sup> As at September 2024.

Figure 6. Metrics retail investment funds

|                                | METRICS DIRECT INCOME FUND (MANAGED FUND)  | METRICS MASTER INCOME TRUST (ASX:MXT)  | METRICS INCOME OPPORTUNITIES TRUST (ASX:MOT)   | METRICS REAL ESTATE MULTI-STRATEGY FUND (ASX:MRE)        |
|--------------------------------|--|--|--|--|
| Structure                      | Unlisted, Open-ended Unit Trust  | ASX Listed Investment Trust  | ASX Listed Investment Trust  | ASX Listed Investment Trust <sup>10</sup>                |
| Inception Date                 | July 2020  | October 2017   | April 2019   | 16 October 2024  |
| Target Net Return <sup>9</sup> | RBA Cash Rate plus 3.25% p.a.  | RBA Cash Rate plus 3.25% p.a.  | Cash Yield: 7% p.a. with upside gains<br>Total Return: 8-10% p.a. over 3-5 yrs                         | Total Return: 10-12%                                     |
| Distributions                  | Monthly  | Monthly  | Monthly  | Monthly  |
| Application/Redemptions        | Monthly  | Daily  | Daily  | Daily <sup>11</sup>                                      |
| Unit Pricing                   | Daily  | Daily  | Daily  | Monthly  |
| How to invest                  | Online via the Metrics website or approved platforms   | Via the ASX  | Via the ASX  | Via the ASX  |
| Research Ratings               | <b>Highly Recommended</b><br>Lonsec, Zenith Investment Partners, BondAdviser<br><b>Recommended+</b><br>Independent Investment Research | <b>Highly Recommended</b><br>Lonsec, Zenith Investment Partners, BondAdviser<br><b>Recommended+</b><br>Independent Investment Research | <b>Recommended</b><br>Lonsec, Zenith Investment Partners, BondAdviser, Independent Investment Research | <b>Recommended</b><br>Lonsec, Zenith Investment Partners |

<sup>9</sup>This is a target return and may not be achieved. Income payments depend on the success of underlying investments and are at the responsible entity's discretion.

<sup>10</sup>The Metrics Real Estate Multi-Strategy Fund is a staple structure comprised of the Metrics Real Estate Multi-Strategy Passive Trust ARSN 679 413 293 (Passive Trust) and the Metrics Real Estate Multi-Strategy Active Trust ARSN 679 413 695 (Active Trust) jointly quoted on the ASX as stapled securities.

<sup>11</sup>Subject to market liquidity.

Figure 7. Metrics wholesale investment funds

|                                | MCP WHOLESAL E INVESTMENTS TRUST                        | MCP DIVERSIFIED AUSTRALIAN SENIOR LOAN FUND             | MCP SECURED PRIVATE DEBT FUND II                 | MCP REAL ESTATE DEBT FUND                        | MCP CREDIT TRUST                                 |
|--------------------------------|---|---|--|--|--|
| Structure                      | Unlisted, Open-ended Unit Trust                         | Unlisted, Open-ended Unit Trust                         | Unlisted, Open-ended Unit Trust                  | Unlisted, Open-ended Unit Trust                  | Unlisted, Open-ended Unit Trust                  |
| Inception Date                 | July 2017   | June 2013   | October 2017                                     | October 2017                                     | December 2018                                    |
| Target Net Return <sup>9</sup> | RBA Cash Rate plus 3.25% p.a.                           | 90-Day BBSW plus 2.75% – 3.25%                          | 90-Day BBSW plus 4.0%                            | 90-Day BBSW plus 5.0%                            | 90-Day BBSW plus 6%<br>Total Return: 11 – 14%    |
| Distributions                  | Monthly Cash or DRP                                     | Monthly Cash or DRP                                     | Monthly Cash or DRP                              | Monthly Cash or DRP                              | Monthly Cash or DRP                              |
| Applications                   | Monthly   | Daily   | Monthly  | Monthly  | Monthly  |
| Redemptions                    | Monthly 15 Business Days Notice                         | Quarterly 90 Days Notice                                | Run-off  | Run-off  | Run-off  |
| Research Ratings               | <b>Highly Recommended</b><br>Zenith Investment Partners | <b>Highly Recommended</b><br>Zenith Investment Partners | <b>Recommended</b><br>Zenith Investment Partners | <b>Recommended</b><br>Zenith Investment Partners | <b>Recommended</b><br>Zenith Investment Partners |

<sup>9</sup>This is a target return and may not be achieved. Income payments depend on the success of underlying investments and are at the responsible entity's discretion.

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If you would like to learn more about Metrics or our funds, contact us on the details below.

**1300 010 311 | [invest@metrics.com.au](mailto:invest@metrics.com.au) | [www.metrics.com.au](http://www.metrics.com.au)**

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This content has been prepared by Metrics Credit Partners Pty Ltd ABN 27 150 646 996 AFSL 416 146 (Metrics), the investment manager of the Trusts and Funds. For further information on the Trusts and Funds please refer to the relevant Product Disclosure Statement (PDS) and Target Market Determination available at [www.metrics.com.au](http://www.metrics.com.au)

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