BondAdviser

# Research Report

Report Created on 28 February 2019

**Issuer Name**

## The Trust Company (RE Services) Limited

**Security Name**

## MCP Income Opportunities Trust

**Security Recommendation**

## Subscribe

**Security Risk**

## High

**Issuer Outlook**

| Improving | **Stable** | Deteriorating |
|---|---|---|

## Key Characteristics

| | | | |
|---|---|---|---|
| **Product Type** | Listed Investment Trust | **Asset Class** | Fixed Income / Alternatives |
| **Issue Size*** | $300,000,000.00 | **Sub-Asset Class** | Private Debt / Equity |
| **Net Asset Value**** | $2.00 | **Investment Manager** | Metrics Credit Partners Pty Ltd |
| **Fixed/Floating** | Fixed and Floating | **Responsible Entity** | The Trust Company (RE) Services Ltd |
| **Payment Frequency** | Quarterly | **Custodian** | Perpetual Corporate Trust Ltd |
| **Target Total Return***** | 8% - 10% p.a | **Administrator/ Unit Registrar** | Mainstream Fund Services Pty Ltd |
| **Target Cash Return***** | 7% p.a. | **Offer Opens** | 12 March 2019 |
| **Franking Credits Incl.** | No | **Offer Closes** | 12 April 2019 |
| **ASX Listed** | Proposed (ASX: MOT) | **Allotment Date** | 23 April 2019 |
| **Convertible** | No | **Commences Trading on ASX** | 29 April 2019 |
| **GICS Sector** | Investment Trust | **First Payment Date****** | After 30 June 2019 |

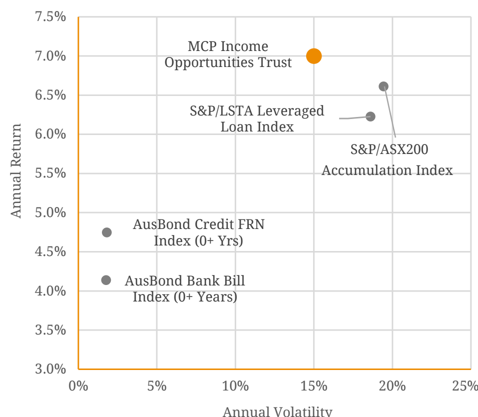
* Issue size subject to change. ** Pro-forma Net Asset Value per unit subject to change. ***First and ongoing distributions are targeted at 7% p.a. cash return but may not be achieved. **** First distribution date is targeted as post the quarter ending 30/06/2019.

## Summary


The MCP Income Opportunities Trust (MOT) is a listed investment trust (LIT) designed to provide investors with access and/or exposure to the Australian multi-asset private credit universe (Prospective ASX Code: MOT). Private credit is a broad asset class that includes investments spanning the entire capital structure, from senior secured loans through to equity-like investments. Private credit is a major pillar of the Australian corporate debt market but has historically been restricted to major global banks and institutional investors. For this reason, MOT offers a unique investment opportunity and exposure to the higher-yielding aspects of corporate credit that are otherwise not accessible for retail investors. Specialist expertise is required to operate in this market and the Metrics Credit Partners' (Metrics) Investment Team is comprised of highly-skilled debt specialists with a strong history of originating, structuring, arranging and managing private debt to Australian companies alongside banks and institutional investors.

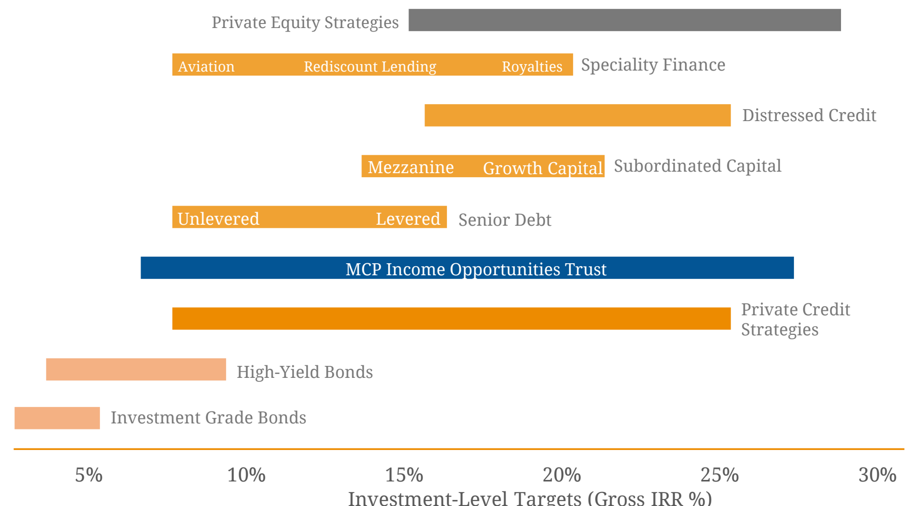
The investment objective of the Trust is to provide attractive risk-adjusted returns (including opportunistically delivering upside gains) while retaining a focus on capital stability, active risk management and downside capital preservation. The Trust is targeting a total net return of 8-10% p.a. (net of fees and expenses) with cash income distributions payable quarterly in arrears, with a target 7% p.a. quarterly cash yield. Similar to Metrics' Master Income Trust (MXT)(which invests in three Metrics wholesale funds via the MCP Wholesale Investment Trust), the Trust will initially invest in the Metrics Wholesale Income Opportunities Trust which will in turn invest in four wholesale private debt funds managed by Metrics. The Trust is expected to list and commence trading on 29 April 2019 at an indicative Net Asset Value (NAV) of $2.00 (equal to the issue price of $2.00 per unit). The Trust Company (RE Services) Limited will serve as the Responsible Entity.


## Figure 1: Risk Return Profile




Source: Bloomberg, Metrics Credit Partners, S&P

## Figure 2: Private Credit Strategies




Source: BondAdviser, Cambridge Associates

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## Security Recommendation - Subscribe *as at 28 February 2019*

This product is recommended for investors looking for higher-yielding exposure across the private debt spectrum without the dilution of yield from investment-grade debt returns. Our basis for recommendation on MOT is a blend of both subjective and objective analysis of the underlying portfolio. Based on our analysis, we believe this product offers investors high risk-adjusted returns via exposure to the multi-asset private credit universe with a focus on sub-investment-grade borrowers.

The Trust will invest in four MCP funds, being the existing Real Estate Debt Fund (REDF), Secured Private Debt Fund (SPDF), Secured Private Debt Fund II (SPDFII) as well as the recently established MCP Credit Trust (MCT). The MCT is an open-ended wholesale unit trust that will differ from the existing funds in that it will provide capital to companies, projects and sponsored special purpose vehicles (SPVs) to provide attractive risk-adjusted returns for investors. The Trust will originate, structure and invest in smaller growth companies across Australia, New Zealand and developed Asia and manage these private credit investments that deliver income and the potential to participate in upside gains while seeking to preserve investor capital.

These investments may include contractually subordinated (junior OpCo) and/or structurally subordinated (senior HoldCo) loans to sub-investment-grade corporates. This subordination in the capital structure increases the risk to the lender via greater exposure at default and potential capital loss, but in our view also provides commensurate compensation in the form of higher fees and yield, as well equity-like upside in some instances.

A listed investment trust (LIT) structure derives unitholder returns from two sources: a) distributions and capital movements in the underlying portfolio, and b) unit price movements which drive the prevailing premium/discount to Net Asset Value (NAV). The latter is a function of market and manager sentiment but also liquidity and structural features of the Trust. The manager has established multiple mechanisms to ensure stability of NAV and trading price. Price movements away from NAV are, in our opinion, speculative and not a function of fundamentals or financial risk management. The former is subject to risks and the Investment Manager's successful implementation of its portfolio strategy and risk framework.

The asymmetric return profile of all credit fund managers means that success of the LIT will be achieved through active risk management at a portfolio level (i.e. diversification) and at an asset level (i.e. loan structuring, covenants). Asset managers who can consistently produce alpha and/or can contribute meaningfully to risk-adjusted returns can only do so by either having a superior investment strategy, access to specialist product and/or have a competitive advantage. While Metrics has a relatively short history of fund performance (~6 years) they have all the key traits of a successful asset manager which is unlikely to change due to their unique investment opportunity set and highly-skilled Investment Team.

For this reason, we recommend investors **subscribe** to the MCP Income Opportunities Trust.

## Positive / Negative Risk Factors

**What factors would change the Recommendation UP**

- Private debt is often secured by tangible assets and rank ahead of other capital investors in an event of default.
- MOT returns are not diluted by lower-yielding senior loans to investment-grade borrowers, increasing risk-adjusted returns for investors.
- Underlying REDF and SPDFII funds now have 1.5 years of trading history and have consistently delivered excess returns over their respective hurdle rates since inception.
- The ability of the Trust to enter into agreements with upside participation rights can increase returns while effectively preserving capital within the portfolio.
- Loans remain the primary funding source for Australian companies resulting in a diverse investment universe across different industries and across the credit risk spectrum.
- Specialist expertise is required to operate in this market which is encompassed in Metrics seasoned Investment Team.
- Metrics has a competitive advantage over banks who have to comply with stringent capital regulation. For this reason, Metrics is able to be more flexible in its investment approach. Further regulatory pressure for banks would result in new investment opportunities for the MOT. We acknowledge APRA has taken a recent interest into shadow banks but this focus has been in the residential mortgage segment rather than the corporate loan market.
- A rising interest rate environment would result in higher loan yields and improve underlying fund performance.
- Losses in the Australian corporate loan market have historically been very low.

**What factors would change the Recommendation DOWN**

- The private debt market is a private market which is less transparent than the corporate bond market.
- The underlying funds have operated throughout a period of fairly benign economic conditions and are yet to be tested in a period of economic distress.
- Given the unit price of the LIT is determined in a public market (ASX), the value of the product will be more sensitive to news flow and other announcements relative to Metrics' wholesale offerings.
- Reputational Risk: Loss of key relationships with clients which may compromise future business.



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- Credit Migration Risk: Credit quality deterioration (or in a worst-case scenario, loan defaults) in the loan portfolio could result in asset write-downs.
- Lower interest rate environment due to additional rate cuts by the RBA would dampen loan yields.
- Investing through contractually (OpCo) or structurally subordinated loans (HoldCo) lowers expected recovery rates and increases the probability of default on individual loans.
- Competition for corporate loans increasing. The penetration of international banks could crowd out smaller participants and result in loan margin compression.
- Common equity investments can boost returns but can also increase portfolio risk at times of corporate stress and loss absorption in the event of default.

## Issuer Outlook - Stable *as at 28 February 2019*

**Performance**

Similar to other debt instruments, private debt (loans) performance is dependent on income and capital valuation. The capital value of loan assets will typically remain anchored around par value (see Valuation section) and because they are not traded, performance is predominantly driven by fees derived from origination and income generated from the interest charged on the loan.

In most cases, loans are priced at an interest rate spread above a floating reference rate (BBSY in Australia). The spread will be contingent on many factors such as size, term, credit risk (and associated covenant package), purpose, the demand/supply dynamics of the market (i.e. business credit availability, alternative funding sources) and can be linked to conditions outlined in the loan agreement with the lender (i.e. credit deterioration, prepayment triggers). With the interest rate representing the ongoing cost of the loan, the lender can also receive various other fees which will add incremental return, including up-front fees, establishment fees and commitment fees. While effectively trying to achieve the same purpose for the issuer, the risks and sources of return are different to the traditional bond market.

MOT is designed to distribute funds across Metrics' existing Secured Private Debt Fund (SPDF), Secured Private Debt Fund II (SPDFII), Real Estate Debt Fund (REDF) and as well as the recently established MCP Credit Trust (MCT). Unlike the existing MCP Master Income Trust (MXT), MOT will have more flexible allocations across the four funds based on the ability to meet its target return of 8-10% p.a. (net of fees and expenses). MOT is able to target a higher return as it is not invested in senior, investment-grade loans and is predominantly focused on private lending further down the capital structure via either contractual (junior OpCo) or structurally (senior HoldCo) subordinated loans. MOT is also able to take on equity positions (where appropriate) to deliver potential upside in specialised financing situations.

While MCT is in ramp-up and thus has no meaningful performance data available, the existing SPDF (November 2015), SPDFII (October 2017) and REDF (October 2017) all have trading histories which can be analysed as a proxy for MCT investments. We note positively that all three funds have consistently outperformed their respective hurdle rates of BBSW + 4.00% (SPDF and SPDF II) and BBSW + 5.00% (REDF) on an annualised basis since inception, delivering returns of 7.92% (SPDF), 8.88% (SPDFII) and 8.14% (REDF). MOT's exposure to the MCT boosts returns by providing exposure to higher-risk private debt, with a hurdle rate of BBSW + 6.00% on the underlying fund.

While these funds are yet to be tested in a severe economic downturn, we remain comfortable with Metrics' extensive experience and prudent mitigants in place to actively manage risk to effectively preserve capital.

**Risk Framework**

Unlike bonds, capital price appreciation for loan assets is rare which emphasises the natural skew in credit investing (i.e. limited upside). It also makes risk management (or price downside) more important. While each loan asset has its own unique risk profile, scale and diversification is required to isolate and control credit risk at a portfolio level. At a loan level, extensive due diligence at all stages of the loan cycle is required and seasoned expertise in loan structuring (i.e. covenants, seniority, collateral) ensures loan level risk is managed. Metrics employs a rigorous risk framework to ensure portfolio quality is maintained and scheduled income is received in a timely manner.

While risk is monitored by the Investment Team on a daily basis, structural risk mitigants at both an individual asset level and aggregate portfolio level underpin Metrics' investment philosophy. Asset selection involves a stringent set of criteria in which potential candidates are reviewed at multiple levels and ultimately decided upon by the Investment Committee (only ~10% of candidates approved). If eligible for the fund, loan agreements will often be secured by tangible assets and will be subject to a custom covenant package tailored to the individual borrower. Risk limits are then set during the portfolio construction phase to ensure sectoral and counterparty diversification is achieved ensuring the portfolio's credit exposure generates a superior risk-adjusted return.

Private multi-asset credit is characterised by targeted covenants, reporting, controls and security which serve to enhance the defensive characteristics of the underlying loans. The private nature of these investments means they carry higher liquidity risk, making the structural features and controls negotiated by the Metrics Investment Team to provide downside protection more important, whilst noting the that equity-style enhancements can also provide upside capital growth opportunities for investors via alternative assets such as warrants, options or outright minority equity ownership.



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Additional risk limits have been set at an individual Metrics fund level in relation to leverage as well as counterparty and sector exposure to further mitigate portfolio risk. However, we note that given the equity-like target returns (8-10% p.a. net of fees and expenses), MOT represents a higher risk investment than the existing MXT available to investors.

**Management**

One of the key elements to this offering is access to an investment manager who operates very differently to traditional investment managers in actively traded assets. The Metrics Investment Team has a long and successful history of providing and managing corporate debt (i.e. loans, bonds and associated products) for corporate borrowers. While many investment managers have access to corporate bonds, the vast majority of corporate debt in Australia is provided in the loan market and more specifically by local and offshore banks. In Australia, the market has almost exclusively been serviced by the major banks (in the past) whereas internationally this is not the case.

High barriers to entry in the domestic loan market are one the key impediments to external investment. A significant and sophisticated asset base is required to even start. It also requires strong relationships, specialist operations, legal and negotiating teams who have sufficient experience to get invited to the table by an arranging party (i.e. corporate adviser, bank etc). The final element is having sufficient knowledge of the market as well as contract and insolvency law experience and knowledge to ensure they can recover invested capital in the event of a default. This is the primary advantage over corporate bonds in which the structural terms provided are generally in favour of the lender (investor in this case) rather than the borrower. While we acknowledge this will not always be the case, Metrics has the advantage of building favourable terms and conditions into loan assets which illustrates management's clear expertise and focus on risk mitigation.

**Market Outlook**

From a lender's perspective, corporate bonds and loans differ by the cost and flexibility of funding models. Bond issuance typically entails higher transaction costs and a higher cost of funding than what would be expected to be incurred for a similar loan. For this reason, it usually suits large corporations with strong, public, investment-grade credit ratings. Due to the relatively complex funding profiles of these companies, bonds will usually coexist with loans to provide diversification in funding sources. Smaller corporations will not have this flexibility and will naturally be more reliant on loan funding for operational and/or growth initiatives. Private companies are even more limited as they are unable to access public capital markets. Consequently, loans are the dominant funding source for most companies due to relative accessibility and cost, meaning the opportunity set within the Australian private debt market is vast.

This leaves Metrics in an enviable position to capitalise on opportunities and offer investors credit exposure historically non-existent outside the walls of a bank. MOT ultimately allows investment across the entire credit spectrum from senior secured loans through to minority equity investments, which, offers investors high risk-adjusted returns in an otherwise inaccessible asset class.

From a fundamental perspective, we see minimal stress across the corporate credit spectrum with systemic risk largely muted with fairly benign economic conditions. There are some pockets of financial distress (i.e. retail, construction and development, engineering services etc.) but this is typically well understood by lenders (including Metrics). We note that the strong track record of the Metrics Investment Team and highly-selective investment process means we remain comfortable with the underlying asset quality within the wholesale funds.

In Australia, Corporate strategy remains focused on corporate activity (i.e. merger and acquisitions), restructuring and cost initiatives which has resulted in typically healthy balance sheets (i.e. low leverage and high liquidity). Systemic market-wide shocks (tail risks) are the primary risk to our thesis for corporates but due to structural features including bespoke covenants and risk management controls, as well as significant lender protection inherent in loan funding, we remain comfortable with the credit risk of the market.

Given our view that we are currently in the mid-to-late stages of the credit cycle, it is important to give context relative to historical default and recovery rates across the credit spectrum. Based on Moody's (global) data from 1987-2017, the average recovery rate for senior secured (i.e. first-lien) loans was 80.2% (up from 78.3% in 2016) and in line with the 20-year average of 80.4%. We note that for mezzanine or junior secured loans (i.e. second-lien) this historical average is 45.28% over the last 30 years the mean is high and we would argue that the average would be higher in credit friendly countries like Australia. However, the difference between senior and mezzanine is the primary justification for the higher expected return.

According to Moody's, the average annual credit loss for corporate debt declined to 0.9% in 2017, while for speculative-grade credit the average loss was approximately 1.4%. Positively, global default rates remain broadly low with a high proportion of global corporate defaults in the Oil & Gas (27%), Retail (14%) and Business Services (10%) sectors in 2017.

Within the Australian private debt market, corporate default rates remain below that of international peers in line with historical trends. There have been several prominent defaults in recent times including unlisted equipment hire company, Emeco (2016), and sandalwood grower, Quintis (2017). While these types of defaults remain rare in Australia at this point in the cycle, the equity upside that was offered to Emeco bondholders as part of a recapitalisation plan, in which they were to receive 34% equity in a newly-merged company, demonstrates the opportunity set available within MOT to tactically participate in such investments.

Ultimately, we note that active risk management and skills of the Investment Team are the key to preserving capital whilst delivering high risk-adjusted returns for investors. In this respect, we are comfortable with Metrics given their history of capital stability and ability to originate, manage and invest tactically across the capital structure throughout different stages of the credit cycle.



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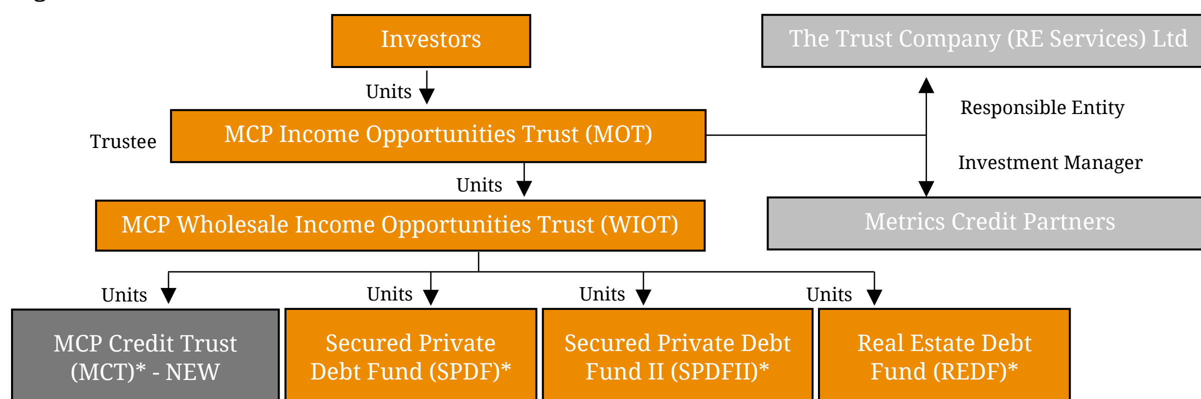
## Asset Allocation and Legal Structure

The legal structure of the MCP Income Opportunities Trust (MOT) is reasonably complex from a high level but protects the unitholder by engaging a separate independent Responsible Entity to act in the best interest of holders. MOT is a passive trust which will invest funds raised into the MCP Wholesale Income Opportunities Trust (WIOT) which in itself has an independent trustee. The WIOT controls the allocation into the underlying funds and assets (see Figure 3).

MOT is targeting a total net return of 8-10% p.a. on average throughout the credit cycle with a target net cash yield of 7% p.a. (post ramp up) (net of all costs and expenses) by investing in Metrics' existing and expansionary wholesale funds. These funds include exposure to MCP's recently established MCT, as well as the existing Secured Private Debt Fund (SPDF), Secured Private Debt Fund II (SPDFII) and Real Estate Debt Fund (REDF). Allocation across the four funds will vary, with final weightings within the Investment Mandate guidelines subject to the Manager's discretion. Importantly, the portfolio is diversified across borrowers, industries and loan products.

**Figure 3. Metrics MOT Structure**




*MCP is the manager of each of the SDPF, SPDFII, REDF and MCT

## Investment Strategy

MOT's Investment Strategy is focused on the success of the investment strategies of the underlying funds in delivering on MOT's investment objectives.

- **Downside risk**: Traditional investment strategies for private debt focus on downside risks with an asymmetric return profile. The investment strategy for MOT reduces some of this skew through the ability to take on potential upside participation positions where appropriate.
- **Screening**: The underlying investment universe is large and Metrics will target sub-investment-grade borrowers seeking a mix of fixed-rate and floating-rate corporate loans across the full credit risk spectrum.
- **Diversification**: The portfolio will be diversified across borrowers, industries, geographies and the credit quality risk spectrum with a focus on Australia, New Zealand and developed Asia.
- **Upside**: MOT will target potential upside gains via negotiated equity-style enhancements (i.e. options, warrants or contractual rights) within loan agreements or hold an equity interest in the company.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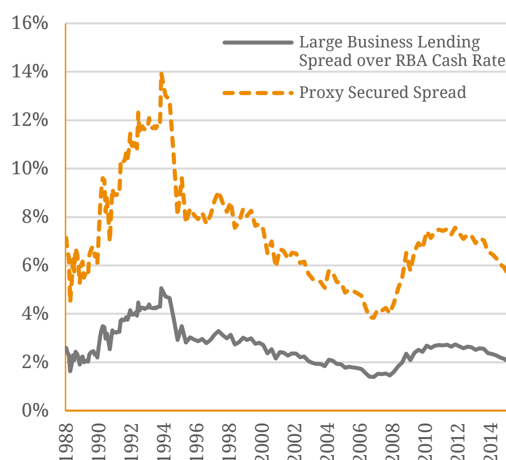
## Risk/Return Analysis

According to Moody's Investor Services, corporate loans have demonstrated a global recovery rate of ~80%, exceeding senior secured bonds (~60%), senior unsecured bonds (~50%) and subordinated bonds (~30%). There is a lack of publicly available data to deduce empirical recovery rates for Australian corporate loans but given the domestic regulatory and legal framework (significant lender protection) and the historical loss rates of the major banks, it is reasonable to assume Australian corporate loan recovery to be closer to 95%.

There is no broad market index for the private debt market which makes it difficult to analyse the sub-asset class on a risk/return basis. The most useful gauge of market characteristics is the regulatory disclosures of the four major Australian banks who dominant corporate lending with a market share of ~75%. Loss rates have been muted throughout the economic cycle which differentiates corporate loans from other corporate debt instruments while data compiled from Moody's indicates historical recovery rates for first-lien loans remain at 80.4%, whilst mezzanine loan recovery is 45.28% based on 30 years of data. We note in the Australian market this recovery rate is typically higher, due to several reasons including the legal / insolvency framework. Given the underdeveloped (and tightly-held) market in Australia, we believe these global rates provide appropriate comparison rates for the broader domestic private debt market.

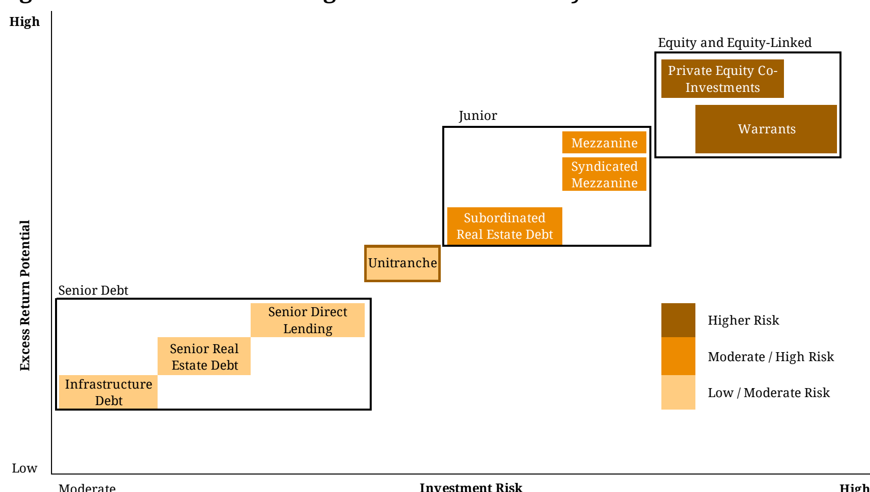
In Figure 4. below, we have used these historical global recovery rates to estimate a proxy spread of private secured debt over the RBA Cash Rate. By using historical RBA data from 1988 to 2018 on large business loan yields and calculating the historical spread to cash rate, we can get a rough estimate of the historical risk-return characteristics in private debt. Given the loans used in the RBA analysis are largely senior secured and are therefore not reflective of the MOT borrower / loan profiles seen in the underlying funds, we have applied a risk multiplier based on first-lien loan recovery rates (80.5%) over mezzanine loan recovery rates (45.28%) to find a proxy secured private debt spread on a historical basis. Based on our analysis, this proxy spread would currently suggest a yield of 750 bps which we view as commensurate to the current risk in this environment.

**Figure 4. Proxy Private Debt Spread to Cash Rate**




Source: RBA, BondAdviser Estimates

**Figure 5. Private Debt Strategies Risk-Return Analysis**




Source: BondAdviser, WillisTowersWatson

Given loans are generally held to maturity by the lender, they are not typically marked-to-market (consistent with a Level 3 asset under AASB accounting standards) for profit purposes as would otherwise occur with other fixed income instruments. For this reason, credit migration risk (i.e. deterioration in the credit quality of an asset) will typically not impact loan profitability in the absence of default. While loan margins are usually fixed, the lender may not be adequately compensated for an increase in credit risk, however, this is typically mitigated by structural terms in documentation which link the margin being linked to credit quality.

For bank lending, negative credit migration will increase the probability of default and hence, the bank will be required to hold more capital against that asset (decreasing its return on capital) but for an equity-funded non-bank lender such as Metrics this is less relevant as they are not leveraged like a bank. As a result, the primary downside risk to a corporate loan is the risk of default (i.e. non-payment of interest and/or principal at maturity or breach of terms). Although counterparty and sector default risk can be reduced through asset diversification, systemic risk (market risk) will always persist.

Mitigation will depend on the effectiveness of individual loan structures (i.e. covenant package, tenor, seniority) to ensure recovery rates remain high in the event of default. Unsurprisingly there is strong positive relationship between credit quality, term and the probability of default (Figure 6. overleaf). For this reason, credit risk migration is closely monitored by lenders and is a key input into loan valuation.



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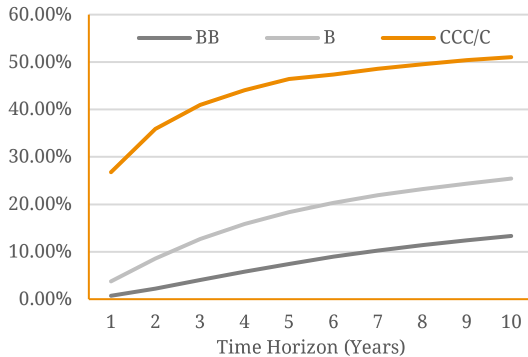
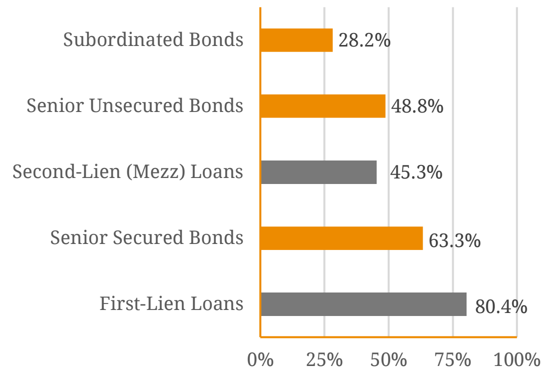
There is also a positive relationship between seniority (in context of the capital structure) and recovery rates. Based on historical S&P corporate recovery data, the higher the ranking the lower the historical probability of default (PD) rates on outstanding corporate debt (Figure 7).

**Figure 6. Global Corporate Average Cumulative Default Rates (1981 – 2016)**




Source: S&P

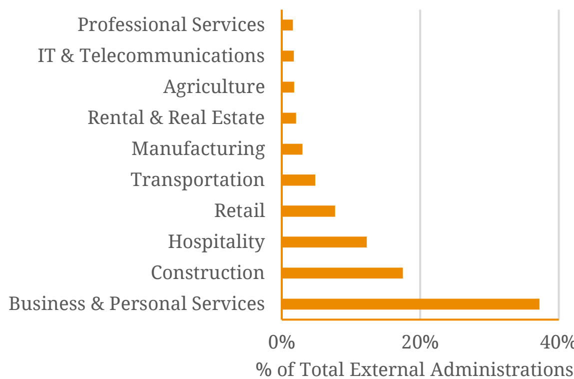
**Figure 7. Corporate Debt Recovery Rates (1987-2015)**




Source: Moody's

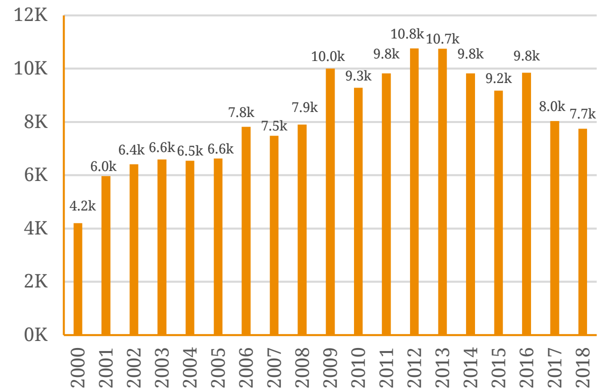
Positively, insolvency data from the Australian Securities and Investments Commission (ASIC) shows that corporate distress levels remain low on a historical basis and have been trending downwards since 2011/2012 (Figure 9). Of those companies entering external administration in 2018 (Figure 8), a significant proportion of these have been concentrated in a handful of industries including Business & Personal Services (~37%), Construction (~17%) and Hospitality (~12%). This is consistent with our thesis surrounding credit quality in these industries and given sound asset quality in Australia at this point in the cycle, we remain comfortable with Metrics Investment Team's ability to achieve its goal of capital preservation and high risk-adjusted returns through MOT.

**Figure 8. 2018 External Administrations by Industry**




Source: ASIC

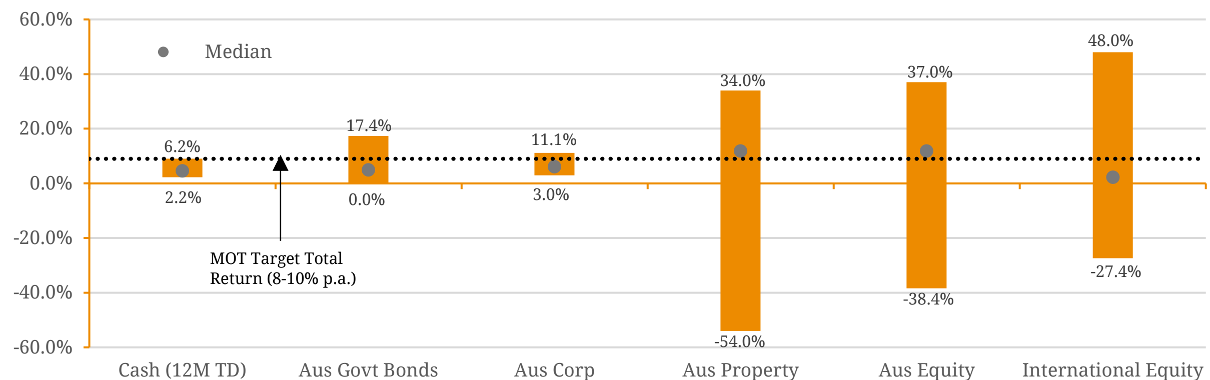
**Figure 9. Number of External Administrations in Australia (2000-2018)**




Source: ASIC

Through its exposure to the underlying wholesale funds, MOT will be exposed to the higher end of the risk-return spectrum within private credit investments. This includes subordinated debt (structurally and/or contractually), distressed debt opportunities and specialty finance. Based on historical risk-return data, the MOT target return of 8-10% p.a. (net of all fees and expenses) remains approximately in line with the historical median return for many of Australia's major asset classes including property and equities (Figure 10).

**Figure 10. Multi-Asset Historical Calendar-Year Return Range (2000 – 2018)**




Source: S&P, Bloomberg



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The most appropriate indicator of performance (albeit limited) is the trailing history of Metrics' existing REDF, SPDF and SPDFII wholesale funds. These funds have performed well since their inception and delivering annualised returns well in excess of their respective benchmarks. We note that on an indicative weighting basis, and assuming each underlying fund achieves only its hurdle rate, MOT would fall short of its target return (Figure 11). However, given the historical (i.e. ex-post) returns on the underlying funds, and assuming that the MCT achieves only its hurdle rate, MOT would meet the bottom range of its target 8-10% p.a. range quite comfortably. This is without considering the potential upside gains that the Metrics Investment Team hopes to achieve (over time) through the indicative 50% fund allocation towards the MCT.

**Figure 11. MOT Pro-Rata Historical Performance (assumed allocations and MCT performance)**

| | Indicative MOT Weight | Target Return | Weighted Benchmark Return (Annualised) | Historical Returns (Annualised) |
|---|---|---|---|---|
| **Prospective MOT** | **N/A** | **8-10% p.a. (net)** | **7.25%*** | **8.19%*** |
| REDF | 25% | BBSW + 5.00% | 6.10% | 8.07% |
| SPDF | 10% | BBSW + 4.00% | 6.10% | 8.04% |
| SPDFII | 15% | BBSW + 4.00% | 7.10% | 8.81% |
| MCT | 50% | BBSW + 6.00% | 8.10% | 8.10% |

Source: BondAdviser Estimates, Company Reports

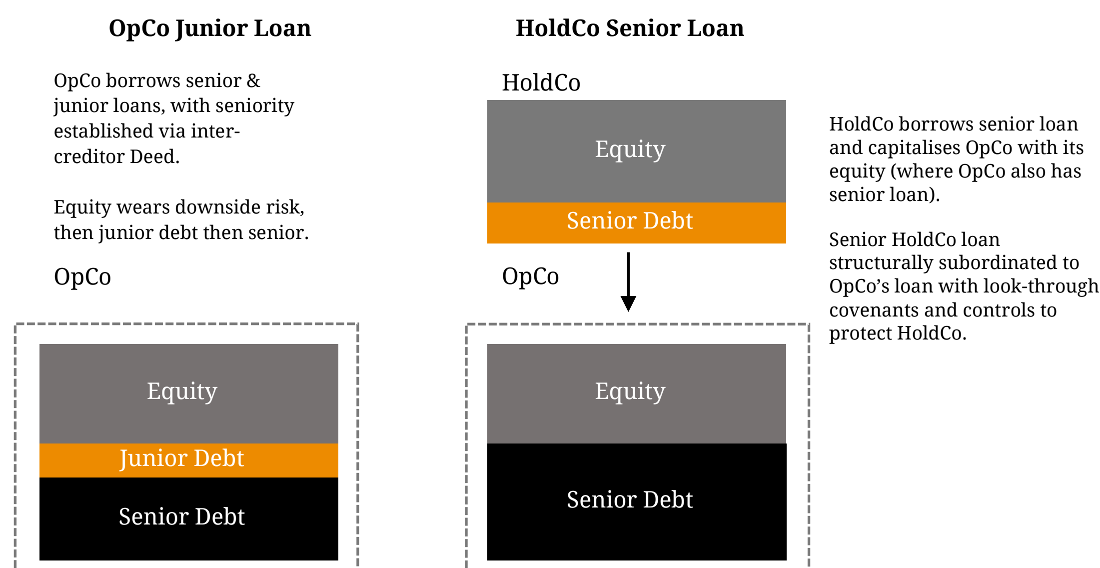
* Based on indicative MOT Weight and the MCT achieving exactly its pro-rata target return of BBSW + 6.00%

We note that while all of these funds have delivered robust risk-adjusted returns for investors, this is based on limited trading history. Nevertheless, we remain comfortable with MOT expected return based on the underlying funds and the experience of the Investment Team.

The ability of the MCT to invest across the entire spectrum allows it to target the higher 8-10% p.a. (net of fees and expenses) return, which is not available via exposure to the REDF and SPDFII funds. The MCT will comprise direct lending investments to sub-investment-grade borrowers including senior secured, junior secured and senior secured holding company (HoldCo) loans.

An operating company (OpCo) junior loan is contractually subordinated, sitting below senior loan facilities provided by a senior lender (i.e. a bank) in the borrower's capital structure (Figure 12). These loans are typically subject to strict covenants and controls with an equity buffer absorbing first losses before reaching the junior debt principal. Based on the restrictive nature of the covenant package, OpCo junior loans usually carry a lower cost of debt than a HoldCo senior debt, which have the advantage of greater flexibility.

**Figure 12. HoldCo Senior vs. OpCo Junior Loan Seniority**




Source: BondAdviser

By providing structurally subordinated or mezzanine financing behind that of the senior lender (i.e. the banks), the MCT can generate returns that would not be possible through exposure to investment-grade exposure.

Although equity optionality and thus upside is received in return; offering loans with subordinated security heightens credit risk. This risk is mitigated by Metrics' stringent and prudent approach to selection criteria (deal timelines take anywhere between 3 and 24 months) as well as the extensive origination, management and restructuring expertise of the Metrics team.



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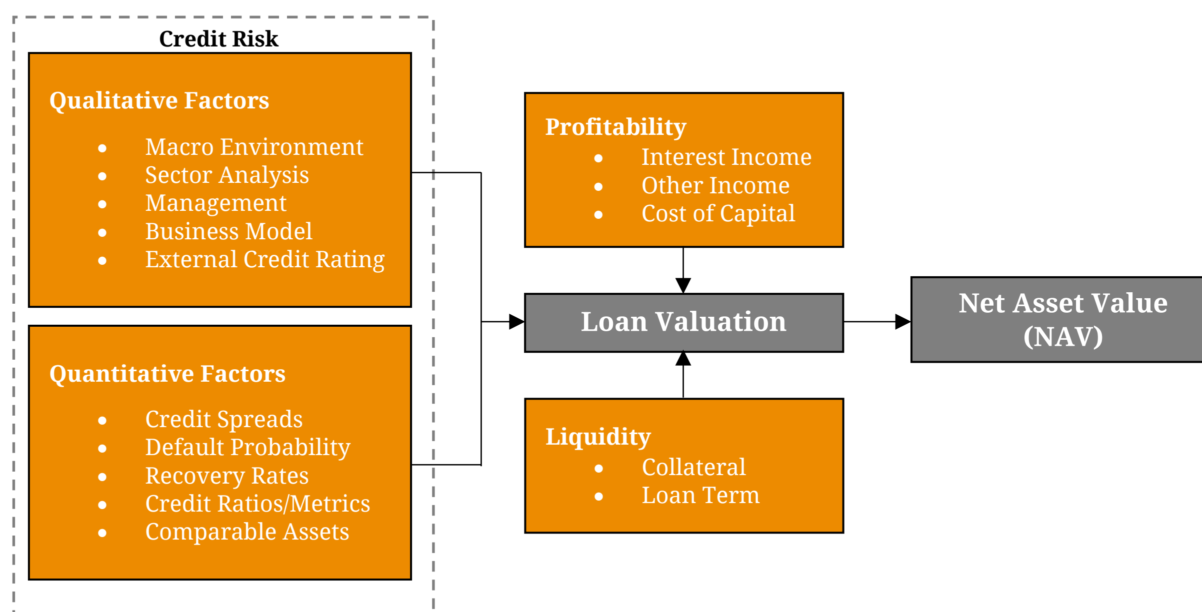
## Valuation Considerations

In an active market (i.e. equity and bonds), the value of an asset for the purposes of calculating Net Asset Value (NAV) is its traded price (fair value hierarchy Level 1). However, where an asset is less actively traded, or a traded price does not exist, the value of an asset for the purposes of calculating Net Asset Value (NAV) is determined in accordance with applicable accounting standards (fair value hierarchy Levels 2 or 3). Due to the relative illiquidity and private nature of the interbank Australian corporate loan market, credit risk is a key input within asset valuation. Credit risk is assessed in terms of a borrower's probability of default (PD), estimated exposure at default (EAD) based on anticipated loan drawdown, and estimated loss-given-default (LGD) if a default has occurred. As such, loans are typically categorised as fair value hierarchy Level 2 assets and include a subjective element in the valuation process. As there is limited transactional data, Metrics utilises multiple channels to compile as much granular valuation source data as possible to deduce capital value.

While loan assets will typically always be priced around par value, potential valuation write-downs will be dependent on the underlying probability of default as well as recovery rates at the point of default. Credit spreads are also a useful market-based indicator of default (credit) risk which can be used on a relative basis against peers to identify fair asset value. These quantitative measures will typically warrant a case-by-case approach with company, sector and macroeconomic factors all coming into play. For each of the underlying funds, if loan assets are held below par, losses will be charged directly against the profit or loss (P&L) statement which will ultimately impact the NAV of the listed MOT. However, unlike bonds, a default on a corporate loan does not automatically lead to certain capital loss, a notion which is supported by Metrics' extensive expertise in workout and corporate recovery situations. In fact, loan structures are manufactured to ensure experienced lenders such as Metrics can participate and act long before an event of default materialises, hence mitigating the potential of capital loss.

We acknowledge Metrics Wholesale Funds can hold equity interests in work-out scenarios, but we believe this flexibility is necessary to ensure the investment manager can expertly recover distressed debts, particularly given the fund can lend at the low-end of sub-investment grade credit.

**Figure 13. The Loan Valuation Process**




Source: BondAdviser

The NAV per Unit of the Trust is expected to be published daily on the website of the Manager and lodged with the ASX (under prudent ASX listing and disclosure rules). Nonetheless, the price of MOT will be subject to market forces and may deviate from the NAV.

We note that the existing MCP Master Income Trust (ASX: MXT) has performed strongly since its IPO in October 2017 and delivered a 5.23% annualised net return against its benchmark of RBA Cash Rate + 3.25% (currently 4.75%). Positively for investors, MXT's NAV has maintained above IPO price ($2.00) and traded at an average premium of 2.90% since listing.

Perpetual Trust Services through its wholly-owned subsidiary The Trust Company (RE Services) Limited will act as the Responsible Entity of MOT and is responsible in determining the issue, application price and withdrawal price for a unit in MOT. Perpetual is also responsible for the pricing policies for each of the underlying funds in which Metrics works in conjunction to identify any risks associated with the underlying assets.

In addition to the Fund's own Asset Valuation policies and procedures, the Trustee has appointed a major international accounting firm to conduct an Independent Credit Portfolio and Market Price Review providing an independent overlay to asset valuation and credit impairment testing on the portfolio on an ongoing basis.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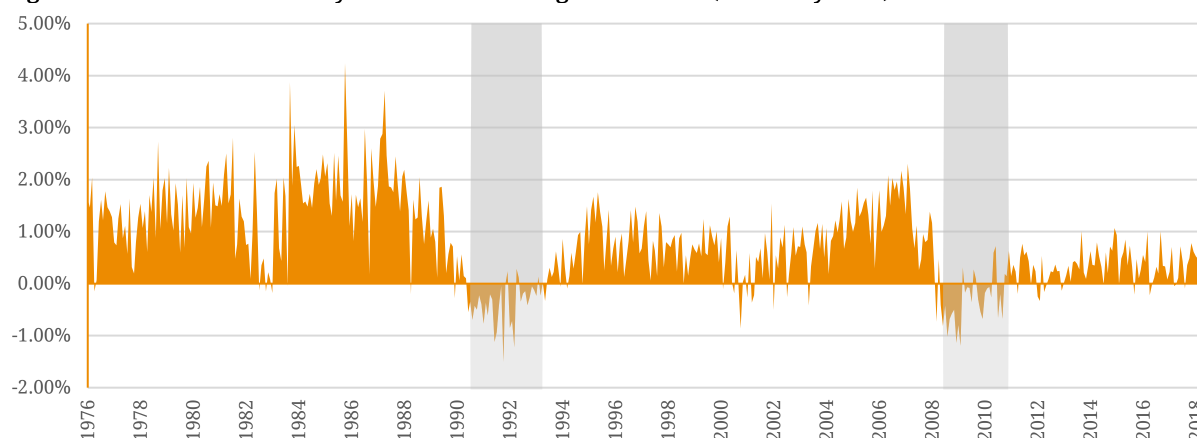
# Industry Background: Australian Multi-Asset Private Credit

The size and scale of the private debt market continues to grow amid structural headwinds facing the Australian banking system. Multi-asset private credit refers to investments across the entire capital structure from senior secured loans through to equity. It is important to note that where held as a loan or debt instrument those private credit investments rank ahead of ordinary equity for payments of distributions and return of capital. Private credit is therefore capable of delivering investors potential upside participation rights whilst achieving focus on risk management and capital preservation within a portfolio.

In its simplest form, a corporate loan is a debt funding arrangement between a company and a lender. The lender typically provides the company with a borrowing facility in which management can choose to draw-down from and repay as it deems fit. Similar to other loans, the company will pay interest on drawn debt and the facility will be subject to a maturity date where renegotiation will generally take place with the lender or the company will look to refinance from other funding sources.

**Figure 14. Australian Monthly Growth in Lending to Business (February 2019)**

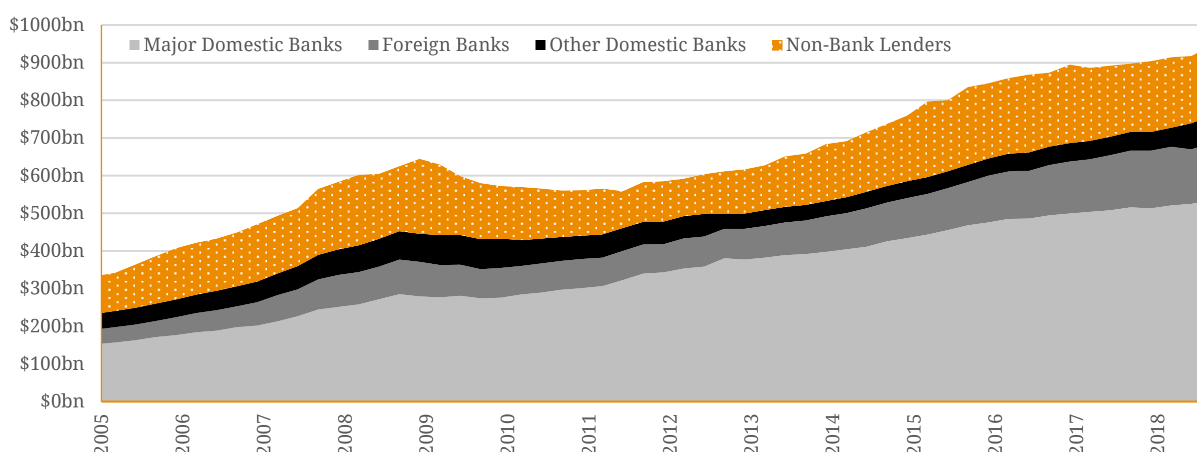



Source: BondAdviser, RBA

Within multi-asset private credit, borrowers may require a variety of financing options for various corporate purposes. Typical borrower profiles range from standard senior secured loans to mid-market corporates and growth / startup companies, whilst bespoke lending may be sought by corporates with a complex capital structure or in sectors experiencing bank withdrawal (i.e. real estate).

Whilst corporate loans contribute ~65% of total Australian debt, tightening lending growth and greater regulatory scrutiny has reduced the traditional bank dominance in domestic private debt and allowed experienced non-bank investors such as Metrics to capture market share. Overall, the corporate loan market presents a largely untapped income opportunity for Australian investors.

**Figure 15. Composition of the Australian Non-Financial Corporate Loan Market**




Source: BondAdviser, ABS, APRA

To fulfill funding requirements, businesses can either choose to raise debt or equity capital which is further segmented into options of varying tenors and structures. Dependent on the arrangement with the lender, loans can be secured against certain assets (i.e. collateral) or unsecured. These obligations can be further classified into different levels of subordination on both a secured and unsecured basis which in turn forms the company's capital structure.



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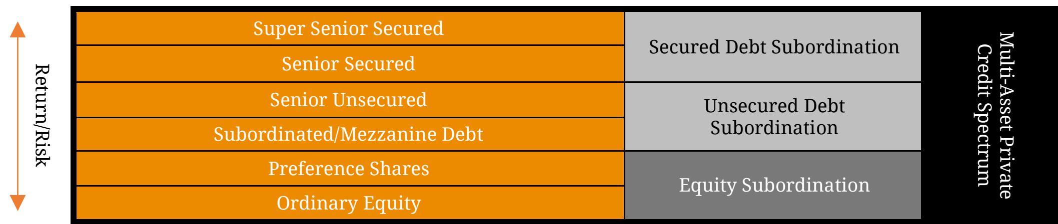
Contingent on the funding requirements of the company, loans can be structured customarily but due to regulatory constraints and internal risk management frameworks, banks primarily loan funds under senior secured rankings arrangements.

**Figure 16. Corporate Capital Structure Example**

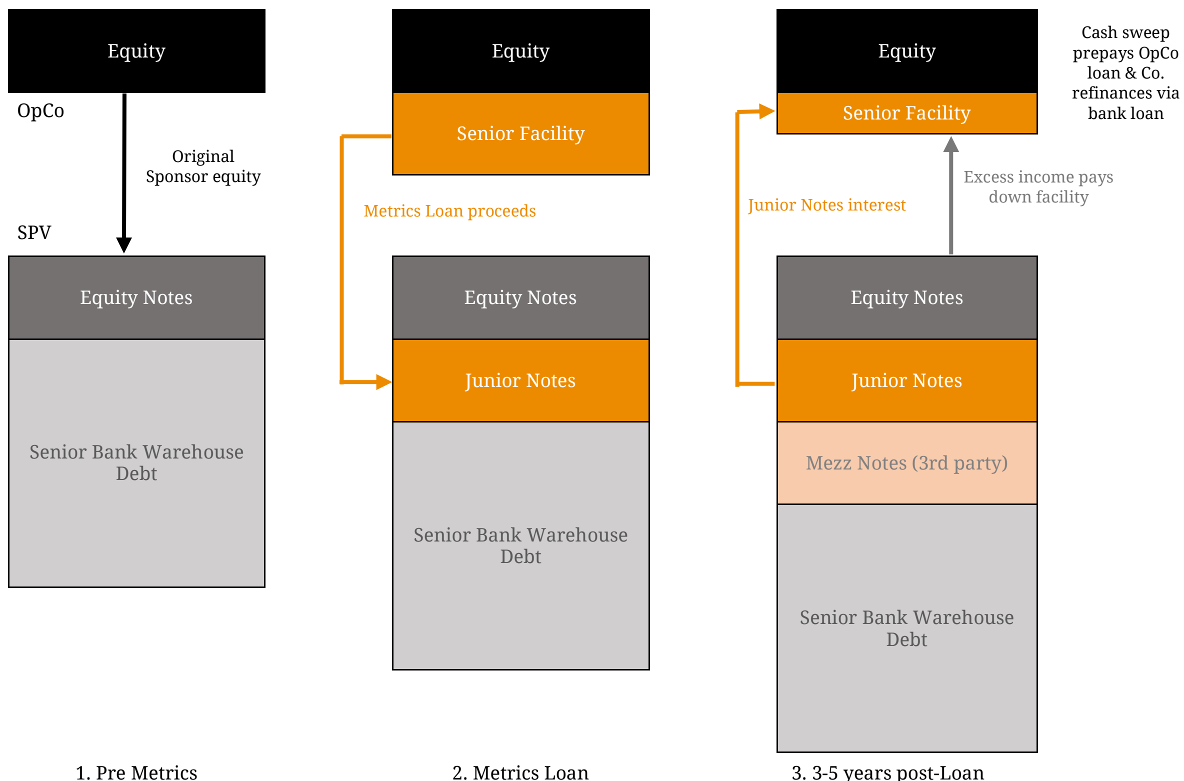



Source: BondAdviser

As a result, secured loans almost always rank ahead of other investors in the capital structure making the sub-asset class to be one of more low-risk investments in the fixed income universe. However, the corporate loan market has lower liquidity relative to other fixed income instruments and valuation is less transparent. For this reason, seasoned expertise is required to operate in this specialist market which, among other things (i.e. capital requirements, regulation), has historically hindered non-bank investment.

By implementing a multi-asset private credit strategy, investors can gain higher risk-adjusted returns than are available when restricted to investment-grade traditional fixed income opportunities. The ability of institutional investors and specialist credit funds to fill the funding gap left by the withdrawal of banks has provided investors with flexibility around which area of the capital structure to target. The higher yielding, higher risk segments (i.e. more equity-like features) can be used tactically to boost returns in specialised and/or situational financing agreements (Figure 17) to supplement capital stability provided by secured corporate loans.

**Figure 17. MCP Provision of Acceleration Capital Example**




Source: BondAdviser, Company Reports

Additionally, the current Australian banking system landscape has created structural tailwinds for multi-asset private credit investors, including:

- An increase in borrower demand due to robust corporate activity and requisite financing has allowed investors such as Metrics to be more selective in where they commit their capital.
- Higher regulatory pressure on the banks and increased scrutiny from the Financial Services Royal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Commission has translated to reduced lending supply, which is unable to meet the sustained demand.

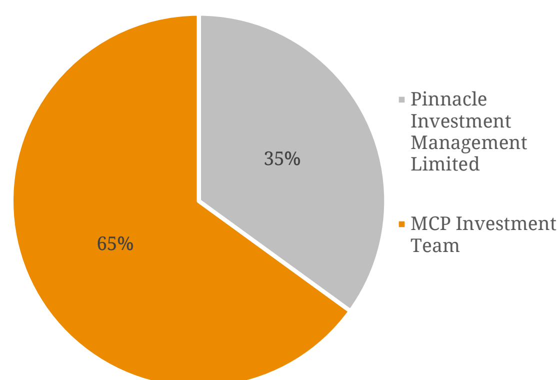
- The persistently low interest rate environment, particularly on the domestic front, has shifted asset allocations towards private credit and away from traditional fixed income instruments (i.e. bonds) in search of higher yielding credit exposure.
- APRA's capital adequacy requirements for the banks has seen internal capital allocations move towards business areas that generate the highest return on equity for the bank, which in turn has reduced banking appetite for corporate loans.
- Corporate asset quality remains intact, with default rates remaining at low levels both domestically and internationally. Significant structural features and controls inherent in private credit agreements, combined with securitisation, affords investors high-yield exposure with downside protection.

## About Metrics Credit Partners

Metrics Credit Partners is an alternative asset manager with specialist skills in fixed income and private credit equity and capital markets, providing expertise to investors seeking opportunities in global debt (credit and fixed income) markets with assets under management (AUM) of $3.36 billion as at December 2018 (Figure 19). Metrics' Investment Team is comprised of senior and experienced market specialists with on average 30 years' experience investing in and managing corporate debt assets (loans, bonds and associated products). Metrics can support investors looking to access corporate debt including listed and unlisted corporates, infrastructure, leveraged & acquisition and property debt, across the full credit risk spectrum.

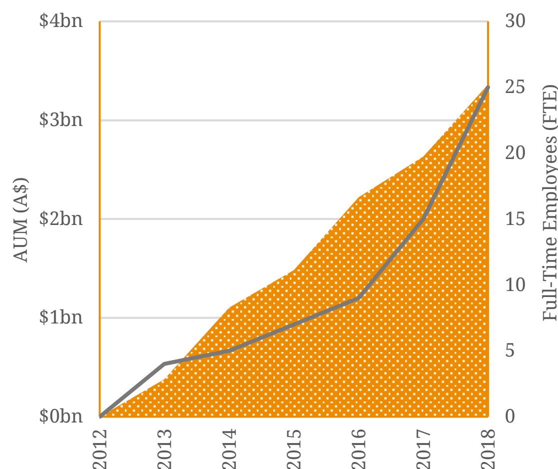
The team responsible for managing the investments of MOT will be led by the Investment Committee which consists of four seasoned professionals who are highly experienced. The Investment Committee is responsible for portfolio construction, investment decisions, borrower engagement, investment monitoring and cash flow management. The four Partners on the Investment Committee collectively own 65% of Metrics, with the remaining 35% being own by Pinnacle Investment Management Limited, a subsidiary of Pinnacle Investment Management Group Limited (ASX: PNI). The summary biographies for each member of the Investment Committee are below.

**Figure 18. MCP Ownership Percentage**




Source: BondAdviser, Company Reports

**Figure 19. MCP Assets Under Management Growth**




Source: BondAdviser, Company Reports

**Investment Committee**

**Justin Hynes** – Justin has considerable loan origination, structuring and portfolio management experience, including workout and restructuring experience. Justin has extensive acquisition and corporate finance experience in both an advisory and principal capacity in Australia and South-East Asia. Justin has approximately 22 years' financial markets experience, and previously specialised in leveraged and acquisition finance as well as corporate finance. Justin holds a Bachelor of Commerce and Bachelor of Japanese Studies from the Australian National University.

**Andrew Lockhart** – Andrew has considerable loan origination, structuring and portfolio risk management experience and has been responsible for the origination and management of large, diversified and complex loan portfolios including considerable corporate restructuring experience. Andrew has approximately 32 years' banking, funds management and financial markets experience and previously specialised in leverage



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and acquisition finance as well as corporate and institutional lending. Andrew holds a Bachelor of Business and Master of Business Administration from the Queensland University of Technology.

**Graham McNamara** – Graham has considerable commercial banking experience covering portfolio risk management, debt origination and distribution, agency management and corporate banking. Graham has approximately 39 years' experience in banking, funds management and financial markets and has established the loan syndications and agency businesses at major Australian banks. Graham served as a director of the Asia Pacific Loan Market Association and was the founding chairman of the Association's Australian Branch. Graham is a Member of the Australian Institute of Company Directors.

**Andrew Tremain** – Andrew has considerable Australian, European and Asian banking experience covering corporate, structured, leverage and acquisition finance, portfolio management and relationship management. Andrew has approximately 32 years' experience and previously specialised in leveraged and acquisition finance as well as loan syndications. Andrew holds a Bachelor of Commerce from Macquarie University.

# Appendix 1: MCP Credit Trust

The MCP Credit Trust (MCT) was established by Metrics to actively invest and manage a large portfolio of illiquid private credit instruments. These assets broadly encompass debt and debt-like instruments across the more opportunistic end of a company's capital structure, providing investors with significant risk-adjusted returns through exposure to private debt.

The target size of the fund is expected to be >$1 billion, consisting of 15-20 investments of $25-75 million in commitment value. These investments will consist of senior and subordinated loans to predominately sub-investment-grade corporates.

Several significant external events affecting the banking industry in recent years have resulted in greater opportunities for non-bank investors in the Australian private debt space. These include the Global Financial Crisis (GFC) affecting the composition and cost of domestic banks' funding mix, whilst the recently-concluded Financial Services Royal Commission has also contributed to higher compliance costs, tighter lending standards and a change in risk tolerance for major lenders.

MCT represents an opportunity for non-bank investors to capture market share and invest in the historically tightly-held market. An Investment Mandate to invest across the capital structure of sub-investment-grade corporates is a key factor behind the target 11-14% p.a. gross return (7% p.a. cash yield). As an aggregator of investor capital, the Fund has overcome market barriers to entry and offers the economies of scale, portfolio diversity and risk-adjusted returns previously available only to the banks.

| Summary | | | |
|---|---|---|---|
| Structure | Open-Ended Unit Trust | Investment Parameters | Limits |
| Indicative MOT Weight | ~50% | Leverage Limit | <50% of GAV |
| Benchmark | 90-Day BBSW | Senior Ranking Limit | N/A |
| Target Return | 11 - 14% p.a. gross | Australian Dollars | N/A |
| No of Assets | 15 – 20 | Australia Domicile Limit | N/A |
| Asset Duration | 3 - 5 Years | Investment Grade Assets | 0% |
| Senior Ranking | N/A | Sub-Investment Grade Assets | 100% |
| Hurdle Rate | 90-Day BBSW + 6.00% | | |

Source: BondAdviser

# Appendix 2: MCP Real Estate Debt Fund Profile

The MCP Real Estate Debt Fund (REDF) invests in and manages a diversified portfolio of Australian Commercial Real Estate (CRE) loans. The fund holds Australian domiciled, diversified investments broadly reflecting the types of lending activities in Australia's CRE debt market. The portfolio is diversified by sector (industrial, retail, residential development and office), geography (across states in both metropolitan and regional corridors), stage of development (development, brownfield and REIT) and position in the capital structure (senior and mezzanine).


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Australia's banks are currently under increasing regulatory pressure to restrict capital to the real estate sector resulting in opportunities to lend beside and at levels previously provided by banks at attractive margins.

Beyond consumer mortgage and investment lending (which is the focus of the current regulatory attention), real estate still represents the largest sector loan exposure for Australia's domestic banks (industrial, retail, residential development and office). Most investors have limited means of accessing this market and lack the scale to achieve a beneficial level of diversification.

The REDF is designed to address this issue and allow eligible wholesale and retail investors (through ASX listed funds) access to a diversified portfolio of CRE debt assets.

| Summary | | | |
|---|---|---|---|
| Structure | Open Ended Unit Trust | Investment Parameters | Limits |
| Indicative MOT Weight | ~25% | Leverage Limit | <50% of GAV |
| Benchmark | 90-Day BBSW | Senior Ranking Limit | >50% |
| Hurdle Return | Benchmark + 5.00% net of fees | Australian Dollars | 100% |
| No of Assets | 17 | Australia Domicile Limit | 100% |
| Asset Duration | 0.5 – 10 Years | Sector Diversification | Across Sectors |
| Senior Ranking | N/A | Geographic Diversification | Australia |

**Figure 22. Historical Annualised Returns**

BBSW
Hurdle Rate
Excess Return
14%
12%
10%
8%
6%
4%
2%
0%
1.85%
1.20%
2.02%
2.63%
3M
6M
1Y
Inception

**Figure 23. Credit Ratings Profile**

80%
70%
60%
50%
40%
30%
20%
10%
0%
72.82%
10.88%
14.75%
> AA
A
BBB
BB
< B

Source: BondAdviser

# Appendix 3: MCP Secured Private Debt Fund Profile

The MCP Secured Private Debt Fund (SPDF) actively invests in and manages a portfolio of Australian mid-market corporate loans. The portfolio will consist of directly originated loans to borrowers diversified across industries and capital structure positioning. Investments will be sub-investment grade and will include senior and subordinated loan assets, reflecting activity in Australia's mid-market corporate loan market.

In addition to Australia's $200 - 250 billion Syndicated & Club-Style Corporate Loan Market, there is a further $200 – 250 billion of less liquid corporate loans provided by banks. Comprising a variety of mid-market corporate, project and asset backed facilities, this market attracts an illiquidity premium currently only available to Australia's major banks.

| Summary | | | |
|---|---|---|---|
| Structure | Closed-Ended Unit Trust | Investment Parameters | Limits |
| MOT Weighting | ~10% | Leverage Limit | <50% of GAV |
| Benchmark | 90-Day BBSW | Senior Ranking Limit | N/A |
| Hurdle Return | Benchmark + 4.00% net of fees | Australian Dollars | 100% |
| No of Assets | 18 | Australia Domicile Limit | 100% |
| Asset Duration | 0.5 – 10 Years | Investment Grade Assets | Minority |
| Senior Ranking | N/A | Sub-Investment Grade Assets | Majority |


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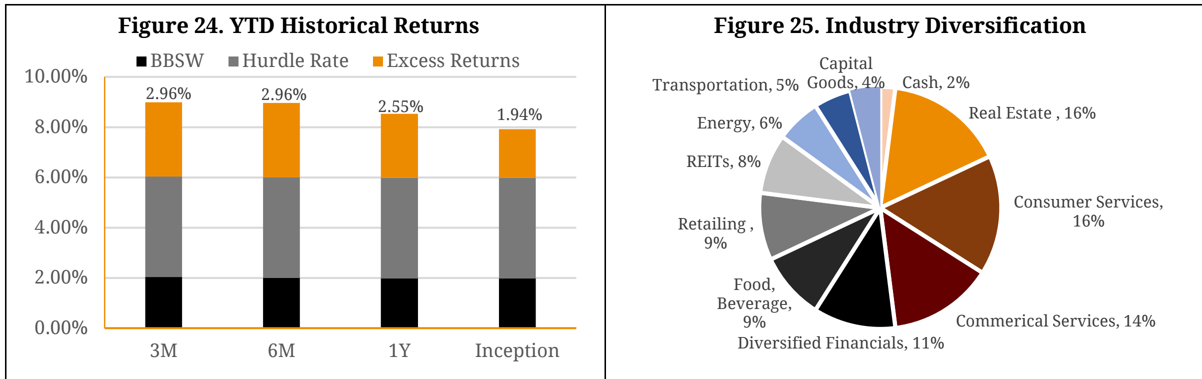
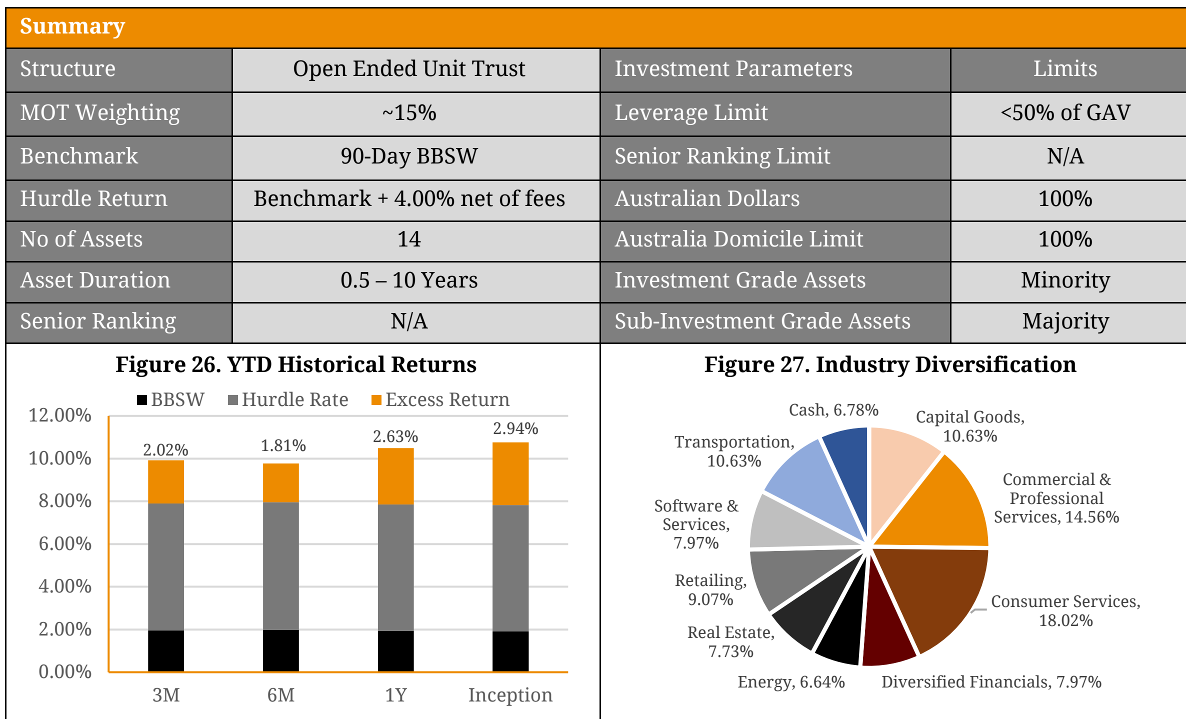



Source: BondAdviser

# Appendix 4: MCP Secured Private Debt Fund II Profile

The MCP Secured Private Debt Fund II (SPDFII), like its older brother (SPDF) actively invests in and manages a portfolio of Australian mid-market corporate loans. The portfolio will consist of directly originated loans to borrowers diversified across industries and capital structure positioning. Investments will be sub-investment grade and will include senior and subordinated loan assets, reflecting activity in Australia's mid-market corporate loan market.



| Summary | | | |
|---|---|---|---|
| Structure | Open Ended Unit Trust | Investment Parameters | Limits |
| MOT Weighting | ~15% | Leverage Limit | <50% of GAV |
| Benchmark | 90-Day BBSW | Senior Ranking Limit | N/A |
| Hurdle Return | Benchmark + 4.00% net of fees | Australian Dollars | 100% |
| No of Assets | 14 | Australia Domicile Limit | 100% |
| Asset Duration | 0.5 – 10 Years | Investment Grade Assets | Minority |
| Senior Ranking | N/A | Sub-Investment Grade Assets | Majority |



Source: BondAdviser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**Research Opinions key**

- **Buy** - Over the next 12 months, the analyst expects the security to outperform the current yield due to credit spread tightening or favourable movements in the underlying yield curve.
- **Hold** - Over the next 12 months, the analyst expects the security to provide stable returns broadly in line with the current yield but with little credit spread tightening.
- **Sell** - Over the next 12 months, the analyst expects the security to underperform the current yield due to credit spread widening or adverse movements in the underlying yield curve.
- **Suspended** - The recommendation has been suspended temporarily due to the disclosure of new information or market events that may have a significant impact on our recommendation. This also includes situations where we have been given non-public information and we need to temporarily suspend our coverage in order to comply with applicable regulations and/or internal policies.
- **Not Rated** - A security that has not been assigned a formal recommendation.
- **Ceased Coverage** - The recommendation has ceased due to issuers failure to disclosure necessary information or coverage is subjectively removed in accordance with our Research Governance Statement.

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