BondAdviser

Research Report

Report Created on 26 February 2018

Issuer Name

The Trust Company (RE Services) Limited

Product Name

MCP Master Income Trust

Product Recommendation

Subscribe

Product Risk

Upper Medium

Product Outlook

Improving	Stable	Deteriorating

Key Characteristics

Product Type	Listed Investment Trust	**Asset Class**	Fixed Income
Issue Size*	[$819,815,882]	**Sub-Asset Class**	Credit
Net Asset Value	$2.00	**Investment Manager**	Metrics Credit Partners Pty Ltd
Current Price	$2.06	**Responsible Entity**	The Trust Company (RE)
Fixed/Floating	Floating	**Custodian**	Perpetual Corporate Trust
Payment Frequency	Monthly	**Administrator/ Unit Registar**	Mainstream Fund Services Pty Ltd
Target Return**	RBA Cash Rate plus 3.25% p.a.	**Offer Opens**	5 March 2018
Current Distribution***	4.75%	**Offer Closes**	29 March 2018
ASX Listed	Yes (ASX Code: MXT)	**Placement Price**	$2.00 (NAV)
Convertible	No	**Allotment Date**	9 April 2018
GICS Sector	Investment Companies	**Normal Trading on ASX**	11 April 2018

*Issue size subject to final size of the entitlement offer and placement. **Distributions target a yield of 3.25% over the RBA Cash Rate but this can be subject to change. ***Based on annualised distribution rate of next distribution.

Summary

The MCP Master Income Trust is a listed income trust designed to provide investors with access or exposure to the Australian corporate loan market (ASX: MXT). This sub asset-class 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, MXT offers a unique investment opportunity and exposure to a market typically not accessible to retail investors.

The investment objective of the trust is to provide stable income with a target return of the RBA cash rate plus 3.25% p.a. (currently 4.75%) after fees payable monthly. The trust has invested in the MCP Wholesale Investments Trust which in turn invests in wholesale diversified corporate loan funds that invest across the credit risk spectrum and are managed by MCP. The Trust Company (RE Services) Limited serves as the Responsible Entity. The trust commenced trading on the 9th of October 2017 on the ASX at a Net Asset Value (NAV) of $2.00 (equal to the issue price of $2.00 per unit).

On the 26th of February 2018, the RE announced an Entitlement Offer and placement to the guided value of $303.6 million. The entitlement offer ratio is 1 new unit for every 1.7 existing units and holders who take up their full entitlement may also apply for new units under the Oversubscription Facility. Any units not taken up under the Entitlement Offer will be offered to new investors under the Shortfall Offer (placement) and a further $77.4 million (to $381 million) can be raised should the Shortfall Offer exceed the guided size of the Entitlement offer.

The offer opens and closes on the 5th and 29th of March 2018 respectively. The additional units are expected to be issued on the 9th of April 2018 at NAV ($2.00) and assuming success, will increase total funds raised to at least ~$820 million.

Figure 1: 10Y Risk and Return

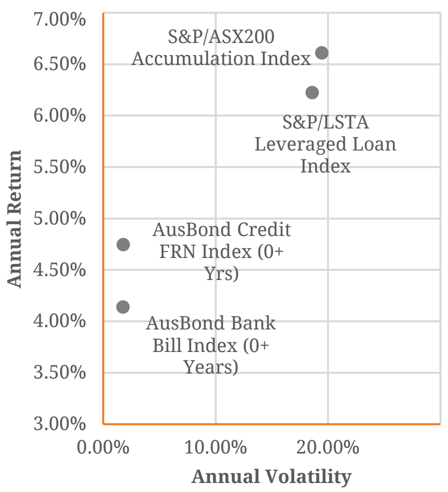
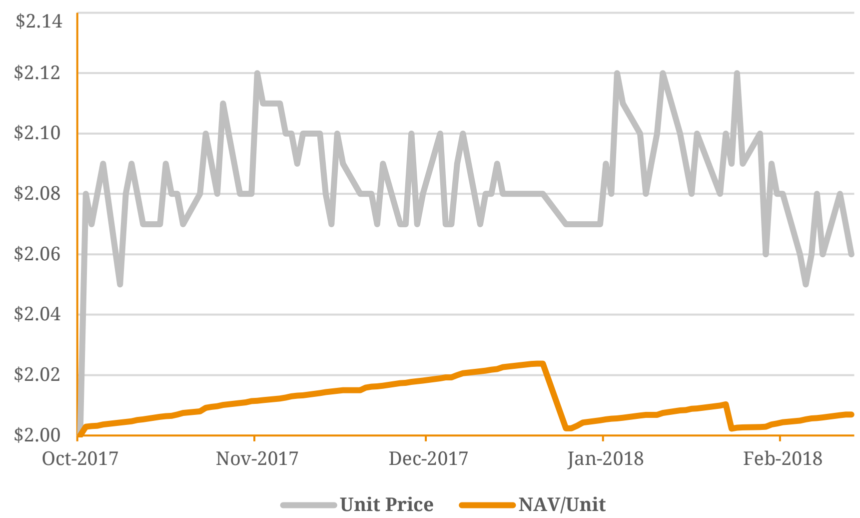


Figure 2: NAV/Unit and Unit Price Performance



Source: Bloomberg, Metrics Credit Partners, S&P

Security Recommendation - Subscribe *as at 26 February 2018*

A Listed Investment Trust (LIT) structure derives unit holder returns from two sources: distributions and capital movements in the underlying portfolio as well as share 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.

Following its successful launch in October 2017, MXT has been met with strong demand in the secondary market. Consequently, units have consistently traded at a premium to NAV highlighting the quality of the underlying funds (sentiment driven). Operationally, the deployment of capital is still underway with MXT currently holding 72 loans, just shy the near term target of 75 – 100 assets which is expected to be reached in coming months. The first distribution was paid in January 2018 at an implied annualised yield of 4.75% (in line with the target return) and NAV has remained stable at $2.00 (on an ex-distribution basis) highlighting the strength of MCP's portfolio strategy and risk framework. We acknowledge going forward that distributions will be paid monthly, with the change in payment frequency recently occurring in February 2018 again in line with the target return.

Overall, MXT has delivered on its targets and performing in-line with our pre-market 'Subscribe' recommendation. MXT continues to provide diversified exposure to corporate loans with returns that are not correlated to equity markets.

Our basis for our ongoing recommendation on MXT is a blend of both subjective and objective analysis of the underlying portfolio. We reiterate that this product offers investors a stable source of income with the margin being offered over the RBA Cash Rate considered fair and commensurate with its risk and the preliminary performance of MXT has confirmed our assumptions to date.

For this reason, we recommend investors **Subscribe** to the MCP Master Income Trust Entitlement Offer and/or placement (Shortfall Offer).

Positive / Negative Risk Factors

What factors would change the Recommendation UP

- Corporate loans are often secured by assets and rank ahead of other capital investors in an event of default.
- 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 MCP's seasoned investment team.
- MCP has a competitive advantage over banks who have to comply with stringent capital regulation. For this reason, MCP is able to be more flexible in its investment approach. Further regulatory pressure for banks would result in new investment opportunities for MXT. 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 corporate loan market is an interbank market which may be viewed as being less transparent than the corporate bond market.
- The underlying funds have a limited track record in 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 MCP's wholesale offerings.
- Reputational Risk: Loss of key relationships with clients which may compromise future business.
- 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.
- Competition for corporate loans increasing. The penetration of international banks could crowd out smaller participants and result in loan margin compression.

Issuer Outlook - Stable *as at 26 February 2018*

Performance

Similar to other debt instruments, loan 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 actively traded, performance is predominantly driven by fees and income derived from origination and participating in underlying corporate loans.

In most cases, corporate loans are priced at an interest rate spread above a floating rate 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 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 result in 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.

MXT is designed to distribute funds across MCP's Diversified Australian Senior Loan Fund (DASLF) and two newer funds which were established simultaneously with MXT. The DASLF represents MCP's core investment offering (~60% indicative weighting in MXT) and has consistently provided positive risk-adjusted returns. The complimentary funds comprise the higher-yielding Real Estate Debt Fund (REDF) and the Secured Private Debt Fund II (SPDF2) where capital deployment is still ongoing but progressing on schedule.

Overall, MXT currently consists of 72 individual investments and we expect this to fall within MCP's initial target of 75 –100 loan assets once full investment of the initial raising is accomplished (expected end of Q118). Nonetheless, the strong price appreciation of MXT has resulted in solid performance for investors over a relatively short period with a return of 5.59% to the end of January 2018. Although this represents a deviation from NAV which should theoretically unwind over the medium-term, it demonstrates the strong underlying demand for MXT and is a testament to the quality of the underlying assets.

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. Similar to the Major Banks (the dominant players in the market), MCP employs a rigorous risk framework to ensure portfolio quality is maintained and scheduled income is received in accordance with contracted obligations with borrowers.

While risk is monitored by the investment team on daily basis, structural risk mitigants at both an individual asset level and aggregate portfolio level underpin MCP's 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. If eligible for the fund, loan agreements will often be secured by 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. MXT will target 75-100 investments with no asset comprising more than 5% of gross asset value. Furthermore, the majority of the loan book will be collateralised under senior ranking arrangements ensuring recovery rates remain high if faced with non-performing assets. Historically, in excess of 90% of Gross Asset Value (GAV) has been structured under senior ranking arrangements in the core DALSF. Additional risk limits have been set at an individual fund level in relation to leverage as well as counterparty and sector exposure.

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 MCP 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 dominated 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 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 to ensure they can recover invested capital prior to 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, MCP 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 borrower's perspective, loans are advantageous due to their cost and flexibility relative to other forms of debt such as bonds. This is partially the reason why loans are the dominant debt funding source for Australian companies. This leaves MCP with a vast opportunity set within the Australian corporate loan market and an enviable position to capitalise on opportunities and offer investors credit exposure historically non-existent outside the walls of a bank.

Fundamentally, we see minimal stress across the corporate credit spectrum with systemic risk largely muted in fairly benign economic conditions. There are some pockets of financial distress (i.e. mining services) and increased risk appetite to participate in mergers and acquisitions (increased leverage) but this is typically well understood by lenders (including MCP).

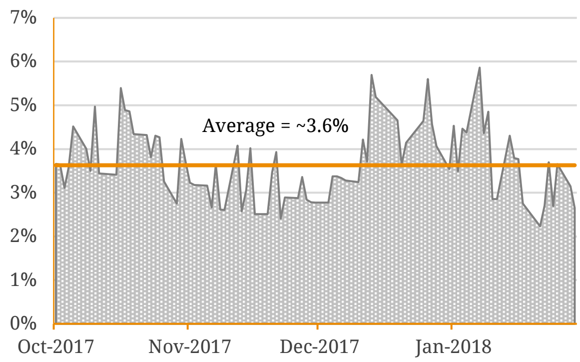
For corporates, internal growth opportunities remain limited in line with a fairly benign economic climate, and as a result, corporate strategy remains anchored to external earnings growth, restructuring and cost initiatives. This has resulted in typically healthy balance sheets with low leverage and high liquidity but history suggests this can reverse quickly if smart acquisitive strategies evolve into speculative corporate activity, especially as the credit cycle progresses. However, balance sheet deterioration and rising default rates are a required precedent and are not a near-term scenario in our opinion. Systemic market-wide shocks (tail risks) are a primary risk to our outlook for corporate credit but due to structural features (i.e. covenants, capital structure) and significant lender protection inherent in loan funding, we remain comfortable with the credit risk of the loan market and MXT.

Master Income Trust Performance Update

Since listing in October 2017, MXT has exhibited strong performance. On a relative basis, MXT has outperformed all other domestic fixed income asset classes to date (see Figure 4) with a return of 1.84% (on a NAV basis). However, due to strong demand in the secondary market, the units have traded consistently above NAV (average premium of ~3.6%) resulting in notable capital gains. As a result, total price return to investors thus far has been 4.54% (Table 1).

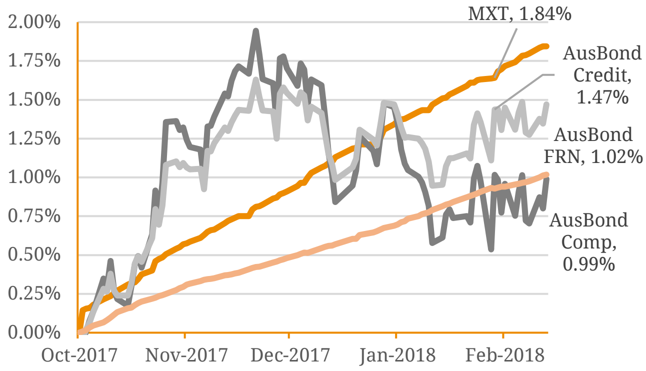
As stated in the pre-market documentation, the first distribution was made for the first three months of trading on the 12th of January 2018 and has now shifted to monthly distributions. The first monthly distribution was made on the 8th of February at an implied annualised distribution rate of 4.874% in line with the product's target return of 4.75% p.a. (RBA Cash Rate + 3.25% throughout the economic cycle).

Figure 3. MXT % Premium to NAV



Source: BondAdviser, MCP (21 February 2018)

Figure 4. Relative Fixed Income Performance (NAV)



Source: BondAdviser, Bloomberg, MCP (21 February 2018)

Table 1. Total Price Return Composition[1]

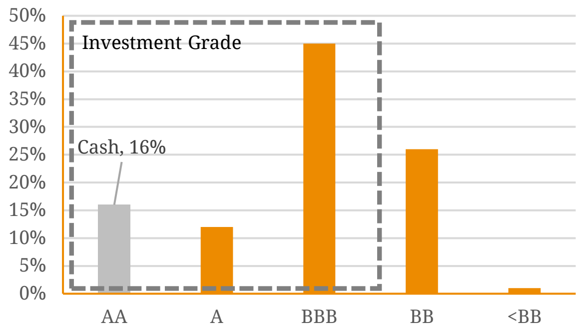
Component	Oct-17	Nov-17	Dec-17	Jan-17	Feb-17 MTD[1]	Total
Market Price	4.54%	(1.78%)	0.11%	1.54%	-1.67%	2.75%
NAV Accruement	0.46%	0.35%	0.37%	(1.06%)	0.23%	0.35%
Income	0.00%	0.00%	0.00%	1.05%	0.39%	1.44%
Price Return	**1.53%**	**(1.43%)**	**0.48%**	**1.53%**	**-1.05%**	**4.54%**

[1] Return calculations based on prevailing market price rather than true NAV. February 2017 reflects Month-To-Date (MTD).
[2] Includes accrued interest.
Source: BondAdviser, MCP (21 February 2018)

Operationally, MCP reaffirmed that it has deployed the proceeds raised into its investment strategy. All funds are expected to be fully invested by the end of Q118 as transactions settle in the near term. Given this accelerated and successful deployment, MCP has announced an offer to raise fresh capital for further expansion of its investment strategy in the corporate loan market.

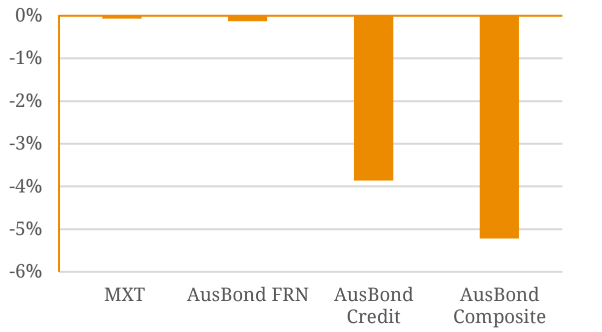
In terms of risk, 74% of assets are investment-grade (Figure 5 – inclusive of 16% cash) while credit duration remains relatively short relative to other asset classes at 2.4 years aligned with MCP's robust risk management framework. Additionally, monthly distributions ensure that interest rate sensitivity remains (Figure 6) negligible which is a major advantage of MXT in the current economic climate.

Figure 5. MXT Rating Distribution



Source: BondAdviser, MCP (31 Jan 2018)

Figure 6. Change in MV for +1% Move in Interest Rates



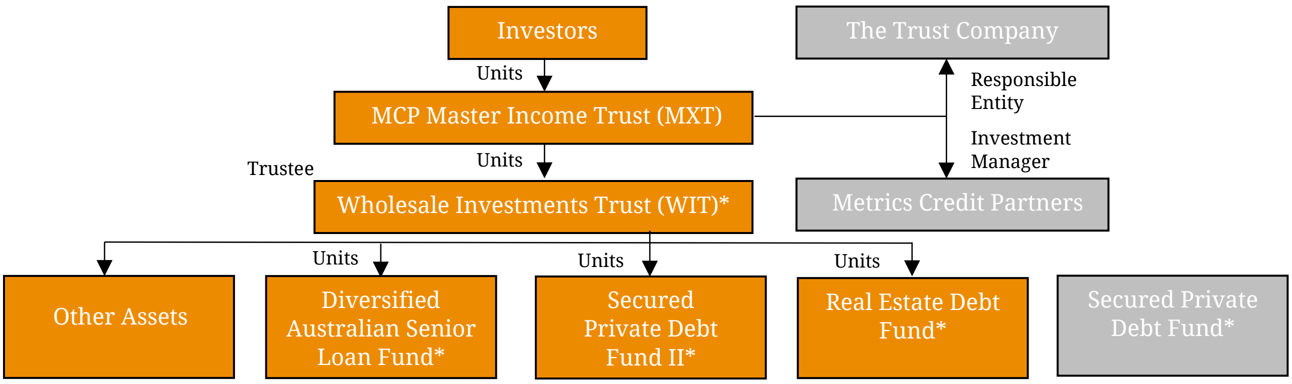
Source: BondAdviser, Bloomberg, MCP (31 Jan 2018)

Asset Allocation and Legal Structure

The legal structure of MXT 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. MXT is a passive trust which will fully invest any funds raised into the MCP Wholesale Investments Trust (WIT) which in itself has an independent trustee. The WIT controls the allocation into the underlying funds and assets (see Figure 7).

The MCP Master Income Trust (MXT) aims to generate a minimum return of the RBA Cash Rate plus 3.25% net of all costs and fees (currently 4.75%) by investing in MCP's wholesale funds. This includes MCP's core Diversified Australian Senior Loan Fund (DASLF), Secured Private Debt Fund II (SPDF2) and Real Estate Debt Fund (REDF). Actual allocation is expected to be 60-70% for DASLF, 20-30% for SPDF II and 10-20% for REDF. The portfolio is diversified across borrowers, industries, credit quality and loan products. The DASLF delivers the majority of investment grade exposure while the SPDF II and REDF provide the bulk of the high- yielding exposures. WIT retains the flexibility to alter the allocation mix to best deliver on the Investment Objective but any changes to allocation of underlying wholesale funds would require Responsible Entity approval. Unitholders will receive advice of any material changes via MCP's website and the ASX.

Figure 7. MXT Structure



Source: Company Reports, *MCP is the manager of each of the DASLF, SPDF, SPDFII, REDF and WIT

Investment Strategy

MXT's investment strategy is focused on the success of the investment strategies of the underlying funds.

- The underlying investment universe will target 75-100 primarily floating rate corporate loan investments promoting diversification and protecting investors against a rising interest rate environment.
- The portfolio will be diversified across industries and the credit quality risk spectrum with limited exposure to the government sector and no exposure to the Australian banking sector.
- Each individual asset is expected to be no greater than 5% of total funds under management.
- On a consolidated basis, the investment universe is expected to comprise ~85% of Australian domiciled borrowers.

The DASLF represents MCP's core investment fund focusing on large scale corporate loan assets across a diverse range of industries. The fund comprises ~57 investments and has an external credit rating of BBB+ by Standard & Poor's (S&P). The DASLF is the longest serving MCP fund and hence, has the most extensive trailing performance history (~5.5% p.a. since inception). In contrast, the SPDF II and REDF are relatively new MCP funds and yet to develop a track record. However, the underlying fund investment mandates and types of loan transactions are consistent with the existing SPDF mandate and transactions/ loans originated and managed by the MCP investment team. The SPDF2 invests in Australia's mid-market corporate loan market with a diversified portfolio of sub-investment grade loans targeting an annual return equal to 4.00% over the 90-Day Bank Bill Swap Rate (BBSW) while the REDF invests in a portfolio of Australian Commercial Real Estate (CRE) debt assets targeting an annual return of 5.00% over the 90-Day BBSW. On this basis and given the indicative weightings, we believe the underlying funds should comfortably meet the MXT's target yield (4.75%).

About Metrics Credit Partners

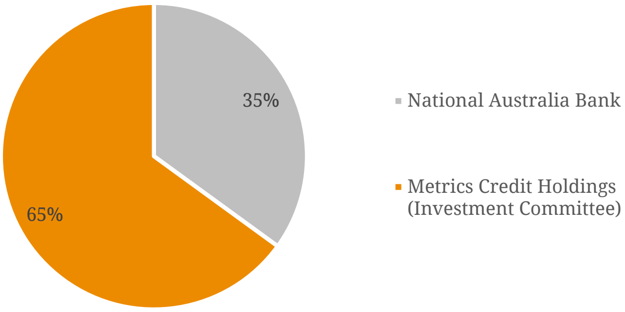
Metrics Credit Partners (MCP) is a specialist fixed income and credit fund manager providing expertise to investors seeking opportunities in global debt (credit and fixed income) markets. MCP's Investment Team is comprised of senior and experienced market specialists with on average 30 years' experience investing in and managing corporate debt assets (loans, bonds and associated products). MCP has the capability to support investors looking to access corporate debt including listed and unlisted corporates, infrastructure, leveraged & acquisition and property debt, across the entire credit risk spectrum.

The team responsible for managing the investments of the MCP Master Income Trust 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 managers on the investment committee collectively own 65% of Metrics Credit Partners Pty Ltd with the remaining 35% being owned by National Australia Bank (ASX: NAB).

It is also important to acknowledge the expansion of the MCP's broader investment functions. Following the launch of the MXT, the company expanded its investment capabilities by recruiting additional experienced analysts across origination, credit analysis and risk management.

The summary biographies for each member for the investment committee are below.

Figure 8. Metrics Credit Partners Ownership Percentage



Source: 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 20 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 management of large, diversified and complex loan portfolios including considerable corporate restructuring experience. Andrew has approximately 30 years' banking, funds management and financial markets experience and previously specialised in leverage and acquisition finance as well as corporate and institutional lending. Andrew holds a Bachelor of Business and Masters 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 37 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 30 years' experience and previously specialised in leveraged and acquisition finance as well as loan syndications. Andrew holds a Bachelor of Commerce from Macquarie University.

Research Methodology

Every research report prepared by BondAdviser includes a clear recommendation - **Buy**, **Hold** or **Sell** - on the security. This recommendation framework is designed to help investors navigate different investment opportunities by identifying the market price, yield, term to maturity, liquidity, volatility and risk.

The guide below may help you understand our research opinions. For further information on our research approach, you can refer to our RG79 statement by **clicking here**.

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 inline 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.

Analyst

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About BondAdviser

BondAdviser is an independent research company that specialises in bonds and fixed income securities. We provide investors, advisers, brokers and institutions with research, data, education and tools to help them invest intelligently. Our service is delivered online via an easy-to-use portal.

BondAdviser has the broadest coverage of retail-accessible ASX-listed and over-the-counter securities, including primary and secondary issues. Our expert credit team draws on its extensive experience and robust research process to deliver unbiased insight backed by detailed analysis.

At BondAdviser, our goal is to lift the lid on the fixed income market so that more investors have the opportunity to invest in the asset class directly.

Learn more

To learn more about the fixed income market visit our website **www.bondadviser.com.au**

Important Information