Fund Research

Metrics Direct Income Fund

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Overview

The Metrics Direct Income Fund (the "Fund", "MDIF") is an unlisted open-ended unit trust, domiciled in Australia, which provides retail investors exposure to the Australian corporate loan market. The Fund invests in wholesale funds that participate across the credit risk spectrum and are managed by Metrics.

Metrics has a similar Fund to MDIF that is listed on the ASX in the "Metrics Master Income Trust" (ASX: MXT). MDIF invests in Metrics funds through its Wholesale Investment Trust (WIT). Both MDIF and MXT invest in the WIT, however, MDIF also has the ability to invest in units of MXT. Both MXT and MDIF may gain exposure to the WIT by way of units or convertible notes in the wholesale funds.

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, MDIF 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 3.35%) **after fees**, payable monthly.

Whilst MDIF has a short track record, MXT has been successfully outperforming its benchmark (the same as MDIF) since inception in October 2017.

Contents

Key Characteristics

Fund Size^	$222 million	**BondAdviser Risk Score**	Lower Medium
Net Asset Value Per Unit*	$1.0332	**Product Assessment**	**Highly Recommended**
Minimum Investment	$1,000	**Outlook / Asset Classification^^**	Stable / Level 3
Fixed / Floating	Predominately Floating	**Structure**	Open-Ended Unit Trust
Distribution Frequency	Monthly	**Sub-Asset Class**	Private Credit
Target Net Return	RBA Cash Rate + 3.25%	**Responsible Entity**	Evolution Trustees Limited
Annualised Net Return^	7.60%	**Administrator**	MCH Fund Administration Services
Annualised Distribution^	4.21%	**Auditor**	KPMG
Mgmt Cost / Perf. Fee**	0.6% / 0.0%	**Valuation Services**	EY

*^ As at 31 July 2021. Since inception where % applicable. ^^ Largely Level 3, however also may include Level 1 & 2 assets. * As at 13 July 2021.* ***** Performance fees are payable on the sub-trusts.*** *Metrics is entitled to 15.375% above the hurdle of BBSW+500 and BBSW+400 on REDF and SPDF II respectively.*

Product Assessment

Highly Recommended

A deteriorating bank appetite for corporate lending has created capital scarcity. This has resulted in ample opportunity and attractive pricing.

MDIF provides retail investors with unique exposure to **domestic corporate lending**. On an underlying basis, the Fund primarily consists of **senior secured floating rate exposure** to both investment grade and sub-investment grade companies. MDIF is a non-listed, open-ended Fund that invests in Metrics Wholesale Investment Trust (WIT) along with the capability to invest in Metrics Master Income Trust (ASX: MXT). MXT exclusively invests in the WIT. While MDIF is in its infancy, we are comforted by MXT's strong track record exceeding the target return for over three years.

This product is best suited for investors looking to generate an **attractive and steady return** from a **diversified portfolio of private loans**. As the asset class matures, we expect the product will exhibit a low long-term correlation to traditional asset classes, making it a suitable diversifier to investor income portfolios, which are typically biased towards domestically sourced, equity-based and/or hybrid income streams.

A **deteriorating bank appetite for corporate lending has created capital scarcity.** This has resulted in ample opportunity and attractive pricing for non-bank lenders such as Metrics. Whilst corporate lending in Australia is still dominated by traditional bank lenders, the ability to provide finance is being squeezed by: (1) additional capital requirements for authorised deposit taking institutions (ADIs) which make sub-investment grade lending unattractive from a return on equity perspective for banks; (2) borrowers demanding customised loans that are non-vanilla in terms of capital structure, covenants and loan structure; and (3) timeliness – bank processes are cumbersome, which is not ideal for borrowers with time-sensitive opportunities.

MDIF has a diversity of more than 180 individual borrowers, with the highest single borrower exposure equal to a mere 2.36% of the portfolio.

Whilst WIT has a revolving credit facility for working capital purposes, it does not utilise leverage for investment purposes, and we do not foresee leverage presenting material concerns. Two of the three sub-funds in WIT (DASLF and REDF) do not have any core debt but can access a revolving facility to meet working capital or drawdown requirements while SPDFII does not have a revolving facility. In other words, leverage is not used to multiply returns. This is an efficient use of gearing that eliminates cash drag of undrawn revolving facilities provided to borrowers.

There is a **high degree of exposure to the real estate sector**, and intra-industry correlations in this space means we are near the limit of our comfort. However, we note **Metrics now have an eight-year record of performance across the business cycle**. Offsetting industry concentration concerns is the diversity of more than 180 individual borrowers, with the **highest single borrower exposure equal to a mere 2.36%** of the portfolio. Additional protections include the short-tenor and floating rate exposure, with an interest duration of 43 days and credit duration of 2.1 years.

The credit quality of MDIF is anchored through predominantly first-lien, short tenured exposure.

The short track record would typically anchor our assessment, however MDIF is eligible for a rare uplift, given: (1) the underlying funds have been individually assessed by BondAdviser; (2) these underlying funds have track record in excess of target returns for the prior two years; and (3) no hedging is required from MDIF into the WIT or MXT in terms of FX exposure. MDIF on a standalone basis would have a product assessment of Approved, however, with MXT carrying a Highly Recommended assessment, MDIF qualifies for a chiral assessment. Accordingly, given Metrics demonstrated skills, systems, and processes, in parallel with a proven investment strategy, we expect MDIF will continue to outperform from a risk-reward perspective, forming the basis for our top tier **Highly Recommended** product assessment.

Investment Strategy & Performance

MDIF's investment strategy is focused on the success of the investment strategies of its underlying wholesale funds.

The underlying investment universe targets primarily floating rate corporate loan investments promoting diversification and protecting investors against a rising interest rate environment. Given it is our opinion that interest rates will rise in the next three years, floating rate credit is our preferred exposure. The portfolio of more than 180 loans is 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 to be no greater than 5% of total funds under management at origination (on the day of investment). Currently the largest exposure is 2.36% and the average exposure is a mere 0.5%. 100% of the loans in the MDIF portfolio are to businesses domiciled in Australia or New Zealand with a target of 80% weighted to Australia.

The portfolio is constructed via investment in three of Metrics' Wholesale Funds via the Sub-Trust. It may also invest directly in MXT (discussed below). The target weightings of investments in the WIT are 60 – 70% in the Diversified Australian Senior Loan Fund (DASLF), 20 – 30% in the Secured Private Debt Fund II (SPDF II) and 10 – 20% in the Real Estate Debt Fund (REDF). Current weightings are approximately 60% DASLF, 20% SPDF II and 20% REDF.

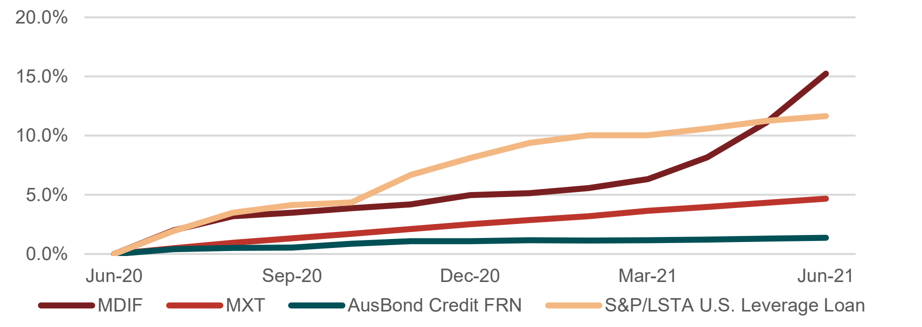
DASLF represents Metrics' core investment Fund focusing on large syndicated, club style and bilateral corporate loan assets across a diverse range of industries. The Fund comprises ~137 investments and has an external credit rating of A- (Stable Outlook) by Standard & Poor's (S&P). The DASLF is the longest serving Metrics Fund and hence has the most extensive trailing performance history (4.60% p.a. net of fees since inception in June 2013 to 30 June 2021).

SPDF II invests in Australia's mid-market corporate loan market with a portfolio (~58 investments) of sub-investment grade loans targeting a minimum annual return equal to 4.00% over the 90-Day Bank Bill Swap Rate (BBSW). Since inception (October 2017), the Fund has returned 7.33% p.a. net of fees.

REDF invests in a portfolio (~53 investments) of Australian Commercial Real Estate (CRE) debt assets targeting a minimum annual return of 5.00% over the 90-Day BBSW. REDF also has an external credit rating of A- from S&P. Since inception (also October 2017), the Fund has returned 7.43% p.a. net of fees.

On this basis and given the indicative weightings, we believe the underlying funds should continue to comfortably meet the MDIF target yield (RBA Cash Rate + 3.25%).

Figure 1. MDIF Performance Against MXT



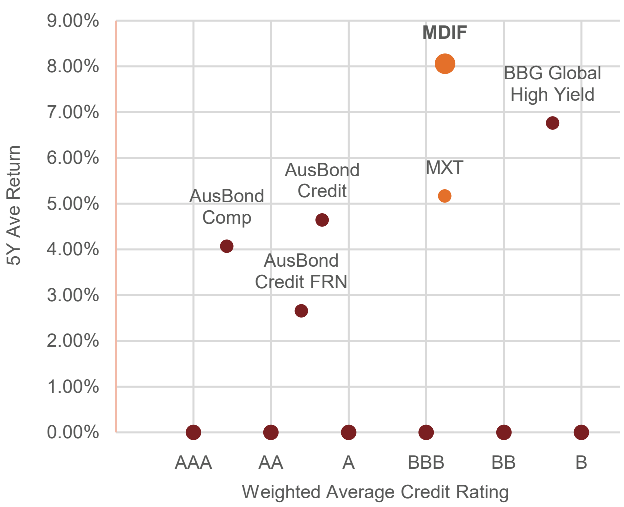
Source: BondAdviser, Metrics Credit Partners. As at 30 June 2021.

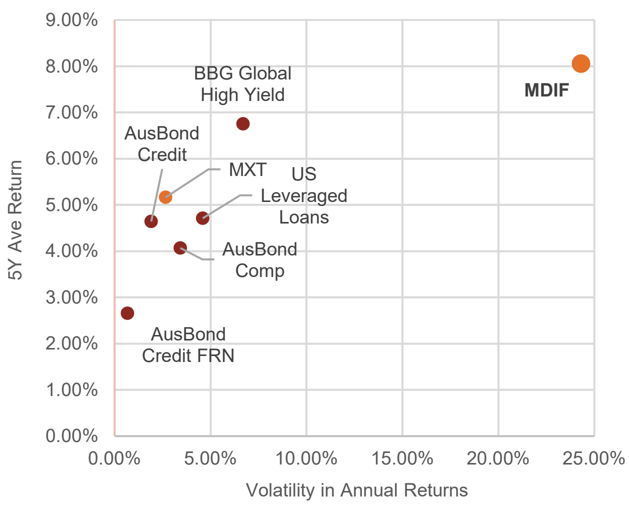
Metrics' listed investment trust MXT also invests in the same sub-trust (WIT), however the MDIF has the ability to transact in shares in MXT. The Funds' investment in MXT at the beginning of its incorporation, when the share price was trading at a discount to NAV, led to strong returns following inception, upon a return to NAV. The differences in monthly returns from MXT and MDIF are almost completely explained by the Funds' investments in MXT shares, as the fees for MDIF are only 1 basis point lower at 0.60% per annum.

In its initial two months, July and August, the Fund's total return exceeded MXT by 2.3% which we explain by the share price appreciation of MXT. At the start of July 2020 MXT was trading at a discount of 6.7% to NAV which soon became a discount of only 2.4% by the start of September. Given MXT has been trading at a modest premium to NAV since the end of December 2020, we do not expect further substantial gains for MDIF to arise from investments in MXT and as such, expect the Fund's returns to much closer track MXT's returns. With MXT trading at a NAV premium, we would be surprised to see a sell down of the MXT units, with returns being driven more by the WIT. Should MXT again trade at a discount, we would expect further exposure in MDIF.

Based on expectations for return and volatility, MDIF has the potential to offer strong risk-adjusted returns relative to the fixed income asset class, as illustrated in Figure 2. A private credit strategy can result in higher risk-adjusted returns than are available when restricted to traditional, investment-grade fixed income opportunities. This is due to two specific premia: illiquidity and complexity. We note the strong duration performance present in the Bloomberg Global High Yield, AusBond Gov and AusBond Credit indices. We do not foresee this continuing across the next five years. Figure 2 uses historical returns, and we recognise in the future that MDIF's volatility will decline as returns become more dependent on the WIT rather than changes in the unit price of MXT.

Figure 2. Estimated Risk-Adjusted Comparison





*All returns for indices calculated using annualised monthly returns for the past five years. Average return for MDIF and MXT calculated since inception in July 2020 and October 2017 respectively. ** Calculated as at 30 June 2021. *** Calculated based on annualised monthly returns data for past five years for indices and since inception for MDIF and MXT.*

Shown below in Figure 3 are the monthly returns for both MDIF and MXT. The reason for the inclusion of MXT here is our expectation for highly correlated returns between the two assets now that the MXT share price is trading closely with NAV. As a result, we expect minimal differences in MDIF and MXT's monthly returns in the future so while MDIF may be in its infancy, we gain insight to expected returns and volatility levels through MXT's data. It is worth noting that as of 30 June 2021, MDIF's holdings are

17.5% in MXT and 82.5% in the Wholesale Investment Trust. With this majority exposure to the WIT, our expectations of high Fund return correlation (on a NAV basis) with MXT are reaffirmed, noting MXT is exclusively invested in WIT.

Figure 3. Past Monthly Net Returns (%)

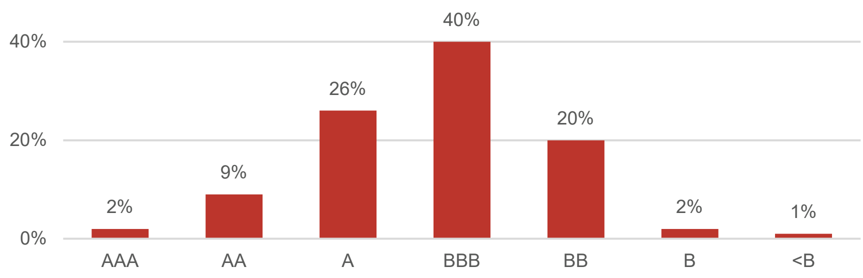
MDIF	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	YTD
2021	0.13	0.43	0.72	0.24	0.77	0.42	0.37						**2.71**
2020							1.99	1.19	0.28	0.35	0.32	0.77	**4.90**

MXT	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	YTD
2021	0.33	0.33	0.43	0.31	0.36	0.32	0.31						**2.08**
2020	0.45	0.41	0.43	0.43	0.39	0.40	0.50	0.44	0.38	0.38	0.40	0.40	**5.01**
2019	0.48	0.47	0.54	0.54	0.52	0.33	0.43	0.43	0.38	0.42	0.42	0.43	**5.39**
2018	0.38	0.32	0.43	0.38	0.38	0.45	0.50	0.49	0.45	0.49	0.47	0.52	**5.26**
2017											0.41	0.35	**0.76**

Source: BondAdviser, Metrics Credit Partners. As at 30 June 2021.

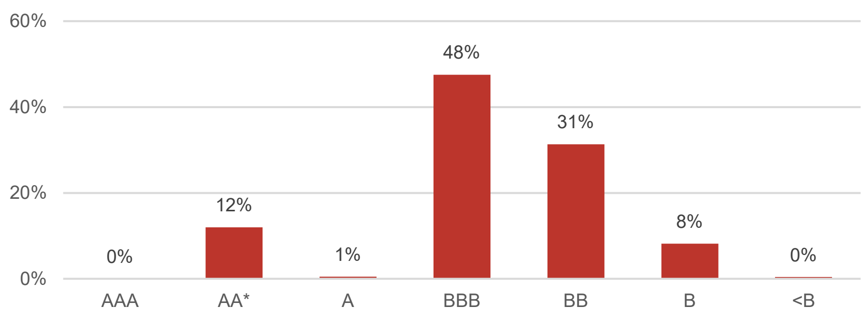
As can be seen below in Figure 5, MDIF does not have exposure to credits AA-rated or higher – its AA-rated holdings comprise its cash balance. As a result of this, the Fund is exposed to lower quality borrowers and higher returns. As discussed in the *Portfolio Risk Management* section, the Fund offsets this higher risk borrowers with high structural ranking with each investment. 97% of the WIT (excluding cash) is ranked senior and 87% of those loans are secured. This strategy provides safety in the event of recovery as a senior lender will be repaid before a subordinated lender or equity holder.

Figure 4. Credit Ratings of Australian Corporate Loans Market



Source: BondAdviser, APRA.

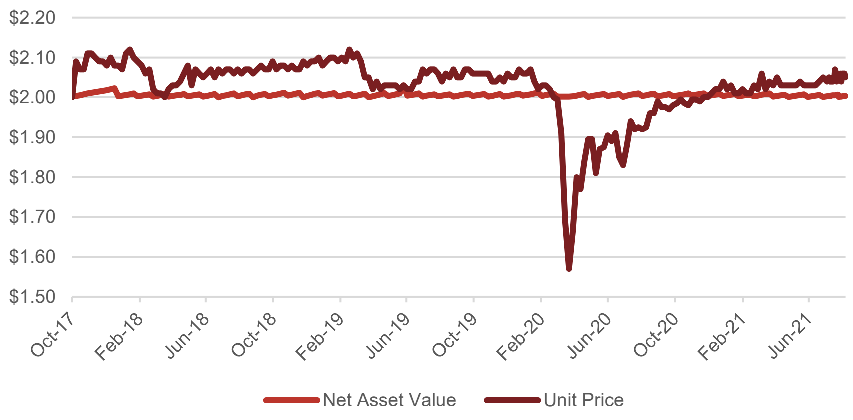
Figure 5. Credit Ratings of Wholesale Investment Trust



Source: BondAdviser, Metrics Credit Partners as at 30 June 2021.
** AA holding represents the WIT cash balance.*

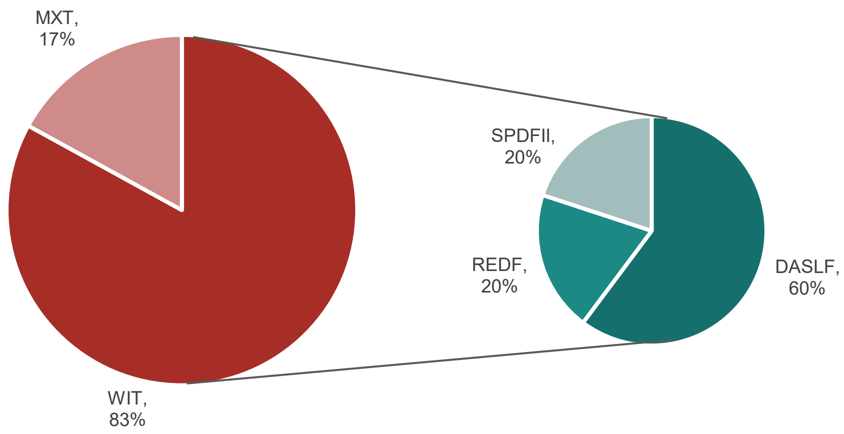
After the inception of MDIF in June 2020, there was clear divergence in net returns between the Fund and MXT. This can be explained exclusively by unit price changes in MXT as it rose to trade above NAV after being significantly below. Given the history of MXT's unit price relative to NAV prior to the pandemic, we expect to see that trend resume for the foreseeable future, withholding any exogenous shocks.

Figure 6. MXT Net Asset Value Against Unit Price



Source: BondAdviser, Metrics Credit Partners. As at 11 August 2021.

Figure 7. Indicative Portfolio Metrics (% GAV)



Source: BondAdviser, Metrics Credit Partners. As at 30 June 2021.

Positive Risk Factors

MXT's Track Record. Although MDIF has a limited track record, we can look to WIT's and therefore MXT's NAV performance as a guide to MDIF's long-term expected risk and return levels. As the Trust was initially used to take advantage of mispricing in the MXT share price which has since returned to pre-pandemic levels, we expect MDIF's returns to largely mimic the returns of MXT. As the Master Income Fund has been operating for over three years, across a distressed environment (COVID), we are comfortable in its average returns and volatility being a strong indicator for MDIF's future expectations.

Origination Pipeline & Expertise. Most corporate financing opportunities are privately arranged, meaning a strong origination pipeline, obtained through relationships with financial sponsors and corporates directly, is critical. Metric's Investment Team has extensive experience in the lending space, through which they have developed a broadly diversified origination network.

Complexity/Illiquidity Premium. The private debt market is niche, with an expanding opportunity set available for competent operators. This expertise drives profitability and a significant expansion of assets under management given the progressive regulatory tightening and pull-back by traditional bank lenders. Due to the lessening appeal for banks to deal in the corporate loans space, Metrics is able to be more flexible in its approach and investment selection.

Established & Repeatable Processes. Management has set up a formalised, two-stage investment process which is repeatable across transactions and manifests a commitment to preserve investor capital. This includes maintaining close engagement with borrowers to enable Metrics to undertake adequate due diligence as well as appropriately manage non-performing assets when required.

Real Asset Collateral. With the majority of the portfolio allocated to senior secured loans, there is substantial protection and benefit. Secured ranking positions preference the Fund ahead of other junior or unsecured creditors in the event of default.

Negative Risk Factors

Liquidity Risk. Direct bi-lateral lending is illiquid and in a stressed scenario, underperforming or defaulted investments may be difficult to liquidate, given there is no real secondary market. The liquidity risk of the Fund is mitigated by the natural run-off afforded by the size of the portfolio.

Long-Term Low Interest Rates. With the RBA cash rate at 0.10% and most loans in the portfolio being floating rate, we are seeing lower yields on investments, however this is not exclusive for MDIF and would be impacting all credit funds.

Credit Risk. Weakening credit profiles of counterparty exposures (or in the worst case scenario a loan default) in the Fund's portfolio could result in a decline in the Fund's net value due to asset write-downs. This is partially offset by protective structural features of the loan arrangements.

Construction and Investment Process

The Fund's investment strategy is underpinned by diversification at the borrower, industry, and credit quality levels. The portfolio lends to over 180 public and private companies with a maximum weighting to any single borrower below 3% of the Trust's total assets (average exposure 0.5%). The Trust will also diversify across industry sectors with the exclusion of the Banking sector. We see this exclusion as a positive as the Banking industry forms such a large portion of the Australian equity market, this exclusion further reduces the correlation to the ASX200 and other similar assets. Additionally, MDIF does not target a particular credit quality and instead lends across the credit spectrum that is reflective of the corporate loan market. Any changes to the investment strategy or objective would require approval by the Responsible Entity (Evolution Trustees).

The Trust has not previously incurred debt nor is there an anticipation that it will require leverage in the future. That said, incurring debt is within the Fund's capabilities and would most likely be used as a temporary aid in the case of funding redemption requests, easing working capital requirements or enabling investment activities. While MDIF itself has no debt, the underlying wholesale funds it invests in do, but only cyclically. The three funds do not operate with core debt, rather leverage refers to a fund's revolving loan facilities to meet drawdown commitments. WIT and REDF both are restricted to leverage no greater than 50% of gross asset value while DASLF is permitted 30% leverage. We are comfortable with these uses and limits of debt and are satisfied to know further leverage at the Trust level will not be used to inflate returns.

Origination & Execution

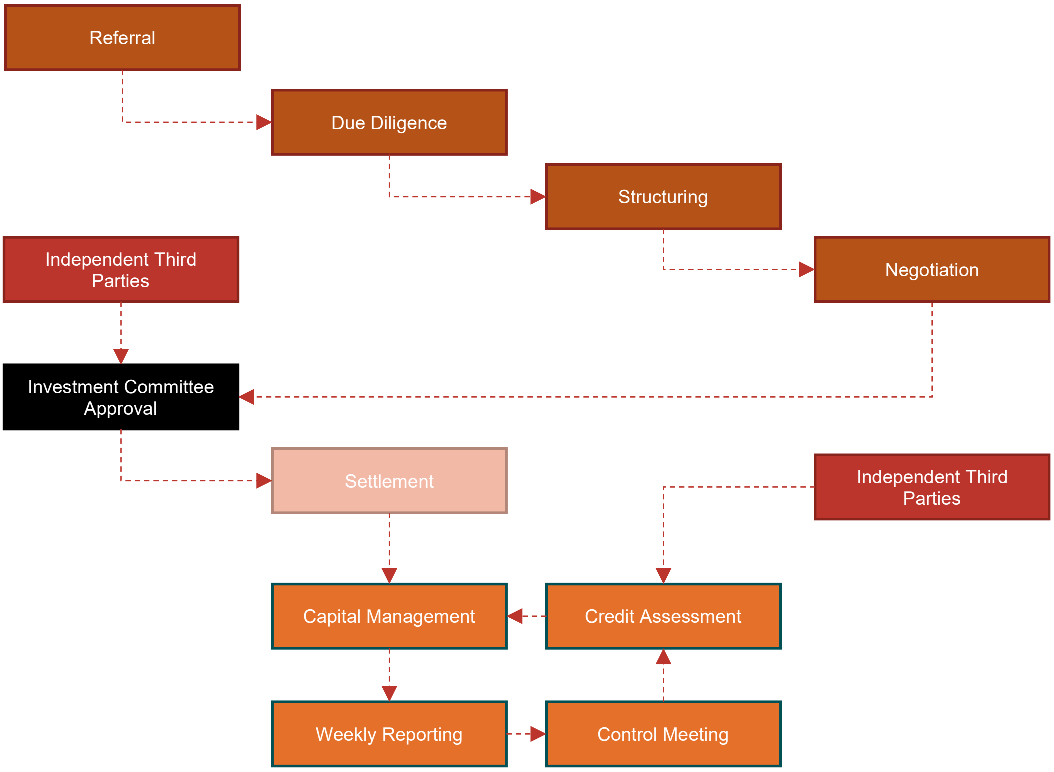
The loan market is the largest pillar of the Australian corporate debt market but has historically been restricted to major domestic and global banks and a few institutional investors. Of late, there has been a shift in the market of corporate loan originators as the regulatory tightening on banks has seen the space become less crowded. MDIF's investment opportunities for its underlying funds are broadly driven by referrals from banks, advisers, private equity sponsors and direct origination with corporate borrowers. This naturally imposes a barrier to entry and highlights the importance of relationships to successfully operate in the Australian corporate loan market, a key competitive advantage of Metrics investment team.

For all three underlying Funds, Metrics follow a two-step process, Origination and then Portfolio Monitoring and Analytics. In the origination phase Metrics has a large network and will regularly be approached with opportunities in either the syndicated or direct loan markets. Additional to Metrics and the other lenders' own due diligence, Metrics engages a number of independent third parties to seek expert opinions including that of lawyers, due diligence advisers, and valuers. While this process does result in significant upfront costs, it is the groundwork in the origination stage that allows Metrics to consistently outperform the market by ensuring the borrower has good credit. It is worth noting that typically all external experts are paid for by the potential borrower, regardless of the transaction outcome.

It is critical to note that all three of the underlying Funds require the majority of loans be secured by assets of the borrowing company which is preferred to the alternative of unsecured borrowing. This safety net adds another layer of comfort in the loan portfolio.

If borrower due diligence is consistent with the investment parameters of the underlying Fund and Metrics risk management framework, an indicative term sheet will be negotiated with the borrower. As corporate loans are quite specialised to meet differing needs, the terms are highly flexible, resulting in this documentation not being standardised and is done on a case-by-case basis. With the loan tailored to fit the borrower's needs, often repayments are aligned with expected cash inflows for the borrower, decreasing the likelihood of default.

Figure 8. Origination and Execution Process



Source: BondAdviser, Metrics Credit Partners

Portfolio Monitoring & Analytics

Post transaction analytics and monitoring involves both the internal Investment Team and several external parties. This process involves the use of extensive reporting tools to collate periodic data on each loan to assess performance against forecasts and to identify idiosyncratic risk in within the portfolio.

As a predominately bi-lateral lender, monthly management financials from borrowers are reported, received and reviewed by Metrics. This access is superior to the syndicated market, which despite reporting more commonly than public markets, is distributed by the agent on a quarterly basis (i.e. less access to management). This frequent interaction with company management, sponsors and owners allows Metrics to better understand credit fundamentals and thereby proactively manage distress or special situations to optimise outcomes for Fund investors. As has been illustrated by Metrics' extensive pre-settlement process and due diligence, return of capital takes priority over return on capital for this direct lending strategy.

The Investment Committee expect to be able to continuously assess underlying credit quality of borrowers. By this, efforts to monitor the portfolio should result in transparency, independence and thoroughness. The transparency achieved from Metrics regularly keeping in touch with borrowers allows it to ensure the Funds continue to outperform as any issues can be managed well in advance.

Portfolio Risk Management

Our assessment of risk management considers credit and liquidity risk. However, we also recognise operating risk is always present and this is considered throughout the report. We view effective risk management as underpinning success, due to the asymmetric nature of credit investment. In Quantitative Analysis we simulate scenarios to test the credit profile of the portfolio, contrasting with this qualitative assessment.

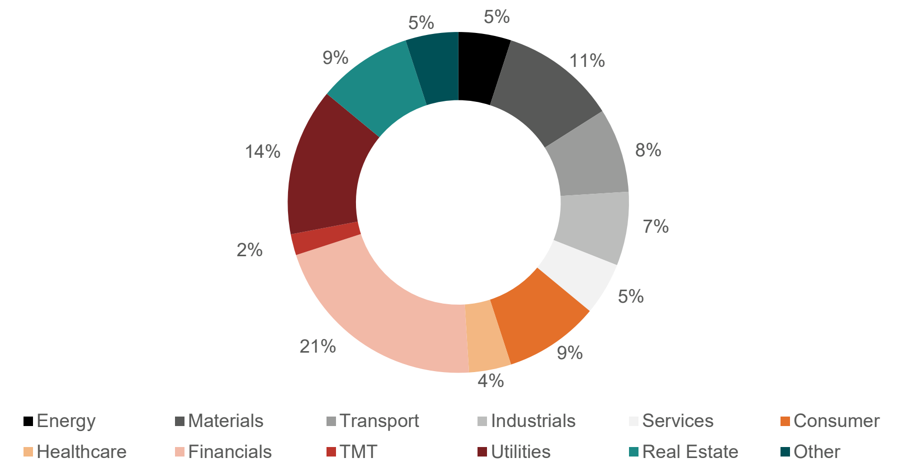
Whilst MDIF has no FX hedging requirements, the sub-trusts may have foreign currency exposure (e.g. NZD, USD, EUR, GBP) should non-AUD loans be originated. The underlying sub-trusts have multi-currency revolving credit facilities, which can be drawn to match any foreign currency loan drawings, eliminating any FX risk. MDIF and its sub-trusts will not enter derivative contracts for speculative purposes.

Credit Risk

Investors' exposure to credit risk is predominantly from credit migration risk (i.e. deterioration in the credit quality of an investment) impacting loan valuation which flows through to lower net asset value. MDIF is invested via the sub trust in a highly diversified portfolio of 185 loans and none of the assets have ever been impaired. Although Metrics have a strong track record, given the Fund lends to predominantly BBB and BB rated borrowers (89.2% of AUM), weakening in the credit of the portfolio is a risk that requires ongoing management.

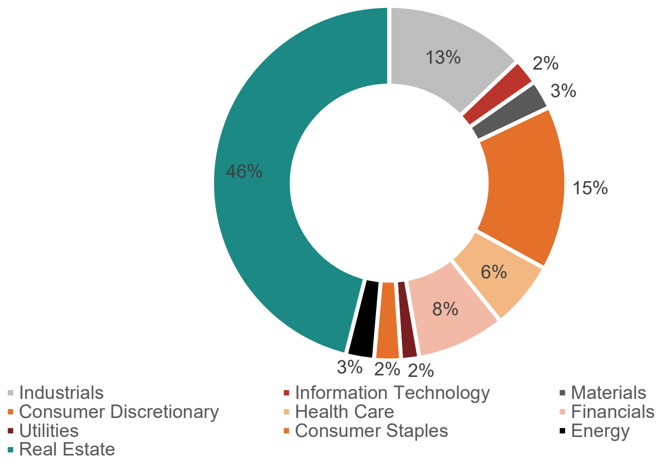
Especially important in understanding the credit risk applicable to MDIF, is the Fund Managers' divergence from the market weightings of corporate loans. Excluding cash as at 30 June 2021 MDIF had allocated 46% of its capital to the Real Estate industry sector, while the weighting in the corporate loans market of Australia is only 9% (*APRA APS 330*). This is split equally between loans to Real Estate Investment Trusts (21.5%) and Real Estate Management and Development (24.5%). MDIF is near the limit of our comfort to this industry and as such the portfolio would be susceptible to a shock to that industry. Although the portfolio is diverse in terms of number of borrowers, we consider there to be some concentration risk at the industry level. As a result, a primary factor when evaluating the credit risk in this portfolio is the inherent credit risk associated with the Real Estate industry.

Figure 9. Corporate Loans Market by Industry Sector



Source: BondAdviser, APRA.

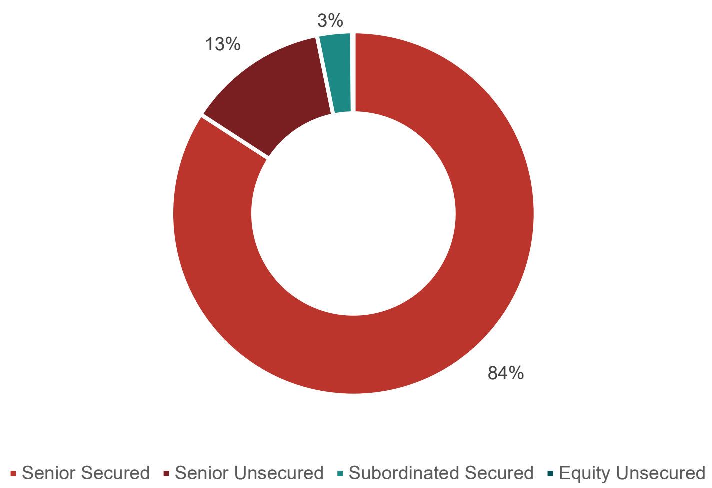
Figure 10. Wholesale Investment Trust by Industry Sector



Source: BondAdviser, Metrics Credit Partners. Excluding cash, as at 30 June 2021.

For a Fund of this nature, that is, an active manager in largely private, investment grade and non-investment grade credit assets, perhaps more important than the credit rating profile of the portfolio is the seniority composition. This is because, as detailed further in the *Risk Management* and *Construction and Investment Process* sections, despite a lower credit rating, investor capital is protected through senior claims to the security of the investment. As is shown in Figure 11, the majority of the Fund (84%) is invested in first lien loans and 13% of the portfolio is invested in senior unsecured loans (second lien). In the event of default, first lien loans must be paid in full before a subordinated lender is repaid. Due to the riskier nature of subordinated loans, they carry a risk premium and as such the target returns for the Fund are lower than alternative funds that invest more heavily in subordinated and equity-like loans. This is entirely appropriate. Senior secured loans have various forms of collateral, including security over the assets of the borrower and real property, limiting the magnitude of downside loss, however not eliminating the risk. In the event of a default, the value of the loan may exceed the security value (collateral risk).

Figure 11. Wholesale Investment Trust Portfolio Ranking



Source: BondAdviser, Metrics Credit Partners. Excluding cash, as at 30 June 2021.

Liquidity Risk

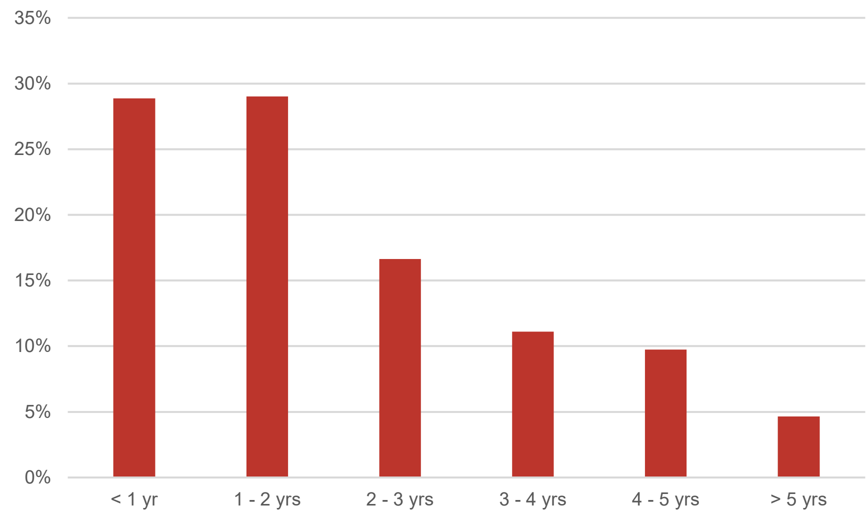
Liquidity risk for the Fund is the ability of MDIF to meet unit holders of the Fund's redemption requests, which can be accepted on a monthly basis.

Loan Liquidity

In order to maximise portfolio return, the Manager aims to have a minimal cash holding and operate close to 100% committed. Interestingly, a quarter of committed loans are not drawn by borrowers, so while there is no drag on holding cash, nominal returns could be higher if more of the committed funds were drawn and therefore earning interest, although the funds earn less significant undrawn fees on undrawn commitments.

The risk therefore is that Fund exposed to both drawn and undrawn loans that may be drawn up or down by the borrower at any time. This revolving nature of some loans may leave the Fund underinvested at times or potentially rushed to supply undrawn facilities to borrowers in cycle peaks. However, the Fund is designed to accommodate both term loans and revolving facilities and **all fund commitments are fully financed**. With the added support of working capital facilities at the fund level to finance this oscillation without causing a cash drag on returns, there is no risk if all undrawn facilities are drawn at once.

Figure 12. Maturity of Loans



Source: BondAdviser, Metrics Credit Partners. As at 30 June 2021.

Fund Liquidity

The Fund will be invested in an illiquid segment of the market – and investments are made with a buy and hold strategy. Given the relative illiquidity of the loans and their expected contractual terms (average credit duration of 2.1 years), **the Fund is suitable for investors with an investment horizon of at least two to three years** looking for regular income, low capital volatility and low correlation with equity markets.

Redemptions are available monthly and while the Responsible Entity (RE) expects that the Trust will be typically liquid, situations may arise where an investor is unable to redeem investments in the Trust. When the Trust is liquid, the RE will accept redemption requests of at least 15 business days prior to the end of the month.

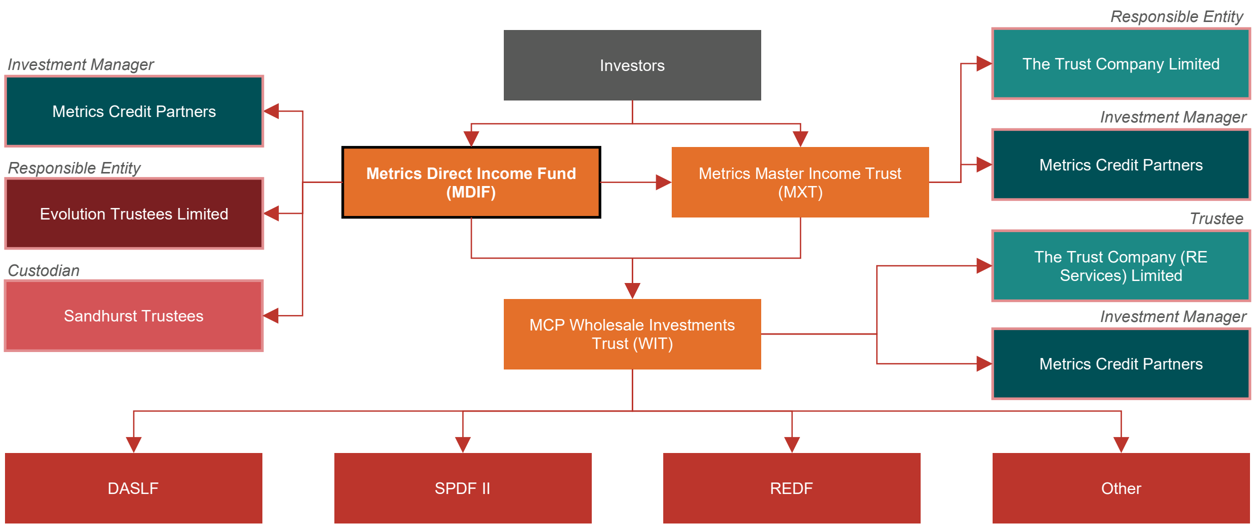
Fund Governance

MDIF is an Australian-domiciled unlisted open-ended unit trust. It is an unregistered managed investment scheme controlled by its governing documents, including the Product Disclosure Statement and the Additional Information Booklet. The Fund is accessible to wholesale and retail investors.

The legal structure of MDIF 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. MDIF is a passive trust which will fully invest any funds raised into (1) the MCP Wholesale Investments Trust (WIT) which itself has an independent trustee, or (2) into units of the Listed Investment Trust MXT. The WIT controls the allocation into the underlying funds and assets (see Figure 13).

The Trustee and Custodian for MDIF are different to MXT and WIT, being Evolution Trustees Limited and Sandhurst Trustees, respectively. This is appropriate as it avoids conflict of interests that are possible given MDIF can invest in MXT. Perpetual Trustees (The Trust Company (RE Services) Limited) is the Trustee and Perpetual Corporate Trust Limited is Custodian of the Metrics Master Income Trust. The Trust Company Limited is Trustee and Perpetual Corporate Trust Limited is custodian of the WIT. As trustee, Evolution issues units in the Fund and is legally responsible to the unitholders for the Fund and its operation. In performance of its duties, The Trust Company has delegated the investment management of the Fund to Metrics Credit Partners.

Figure 13. Legal Structure



Source: BondAdviser, Metrics Credit Partners.

Determination of Net Asset Value is at the discretion of the Manager and there is no assurance that the calculations will reflect actual value nor that the accuracy of these calculations will be verifiable. The valuation of each loan in the portfolio reflects the fact that they are not generally for sale and held to maturity. EY is engaged to provide impairment testing and independent valuation assessment of the NAV of each of the wholesale funds on an ongoing basis. The NAV of MXT is updated daily and its unit price is quoted on the ASX.

Quantitative Analysis

Limited publicly available data and the inherent opacity of direct and syndicated lending makes quantitative analysis of expected credit loss inherently more challenging than for other more transparent and developed asset classes. Whilst this is a positive in terms of a complexity premium, there is difficulty in applying traditional quantitative credit loss models, given the bespoke nature of investments. Though imperfect, the analysis presented in this section does provide an indication of the fundamentals underpinning the Fund.

We have adopted the CreditMetrics framework, which attempts to model credit migrations, including jump to defaults (JTD), that directly impact the valuation of the Fund. Based on historical and estimated fair value yield curves, we can revalue each individual holding for each derived credit rating, which is intended to simulate the likelihood and severity of deterioration in security values, as would be expected as part of the valuations process. The core of the analysis, however, is determined by the probabilities of a JTD and the ultimate recovery given default (loss given default, LGD). Our analysis places no limit on adverse credit migration to model a possible worse-case scenario for investors. We note this approach makes no implicit assumptions on Metrics proven capability to avoid capital losses.

We model the probability of JTD and mark-to-market losses from historical data, known as transition rates (Table 1). This data reflects long-term statistics (1970-2020) regarding the probability of an issuer moving from its current credit rating over a one-year period, and, in the event of default, the average ultimate recovery is based on priority of repayment (seniority). Although the investment horizon is beyond one year, we apply a one-year credit migration outlook for the quantitative framework to limit the uncertainty of variables.

Table 1. Adjusted* Avg. Migration Rates (1970-2020)

FROM\TO	AAA	AA	A	BBB	BB	B	CCC	Default
AAA	**91.2%**	8.1%	0.6%	0.1%	0.0%	0.0%	0.0%	0.0%
AA	0.0%	**87.3%**	9.0%	1.2%	0.7%	0.7%	0.6%	0.5%
A	0.0%	0.0%	**91.3%**	5.9%	1.1%	0.7%	0.6%	0.5%
BBB	0.0%	0.0%	0.0%	**92.4%**	4.6%	1.2%	1.0%	0.8%
BB	0.0%	0.0%	0.0%	0.0%	**85.4%**	8.0%	3.2%	3.3%
B	0.0%	0.0%	0.0%	0.0%	0.0%	**83.4%**	10.1%	6.5%
CCC	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	**87.0%**	13.0%

Source: BondAdviser, Moody's
** Adjusted to account for withdrawn ratings and to eliminate probability of an upgrade or upwards revaluation.*

For each rating rank and for most of the portfolio, an instrument's credit rating is likely to remain static over the modelled timeframe, with some probability of an adverse movement. This highlights that credit ratings are negatively skewed, which is amplified for loans in our analysis, by explicitly eliminating any probability of a ratings increase, given for the infrequency that loans are revalued upwards of par. Our analysis builds on the principles behind Merton's structural credit model to randomly generate a series of credit ratings in one year's time. The core assumption is that the value of an asset in one year is determined by the credit rating or default, of the issuer at that time.

For some of the portfolio, external public credit ratings may be available. Alternatively, Metrics may conduct shadow credit ratings based on S&P and Moody's methodologies. We have reviewed this process and view it as being in-line with market conventions. For otherwise unrated assets, for the purpose of our analysis, we assign a proxy rating of CCC.

We simulate 10,000 scenarios for each set of assumptions, where each portfolio asset has an end credit rating defined by transition probabilities. Mapping valuation changes, or loss given default, to these hypothetical states, allows us to derive a probability distribution of portfolio valuation. The revaluation overlay allows us to estimate (unrealised) mark-to-market losses over a one-year horizon. The primary driver of our scenarios is contingent on JTD and LGD rates.

Additionally, in selected figures (curves labelled: w/income) we have included the estimated impact of coupon carry for the year (noting we do not subtract management fees nor add origination fees). These curves illustrate the offsetting impact interest payments have against credit migration losses. When an individual asset adversely jumps to default (JTD) in any single scenario, we assume no interest payments are made. In evaluating a recovery value in a JTD event, we simulate a random variable utilising a beta-distribution. Distributions vary by seniority and are constructed using largely historical data (Table 2).

Table 2. Recovery Rate Inputs (Bonds and Loans)*

	1970 - 2020 Average	GFC Scenario	Benign Scenario
First Lien Loans	77%	70%	84%
Senior Secured^	59%	43%	60%
Senior Unsecured^	43%	27%	44%
Subordinated^^	32%	22%	33%
Equity**	10%	5%	15%

Source: BondAdviser, Moody's, S&P
** Individual recovery rates will vary, based on a simulated random variable utilising a beta-distribution, using mean and variance parameterisation.*
*** Not empirically based, standardised across all BondAdviser QA testing as a punitive input. Constant standard deviation of 10% used for equity.*
^ Based on bond recoveries only.
^^ Based on bond and loan recoveries.

Downwards revaluations of a loan asset will directly impact MDIF, this decision can be subjective and binary which makes it difficult to model with respect to credit risk. We impair assets for any level of negative migration, reflecting the higher discount rate implied by a greater probability of default, this is not dissimilar to the expected market reaction, where expected loss is marked-to-market. Given the largely bilateral, private credit nature of the loans, we have been more punitive on our mark-to-market revaluations. We would only expect impairments to be recognised upon non-performance where a loan is under-collateralised. Given this difference, our modelling will have a more continuous distribution, whereas we would empirically expect a bimodal distribution. Furthermore, we assume there is no migration upwards and that assets are priced at par unless impaired or in default.

Table 3. Adjusted* Benign Migration Rates (2018)

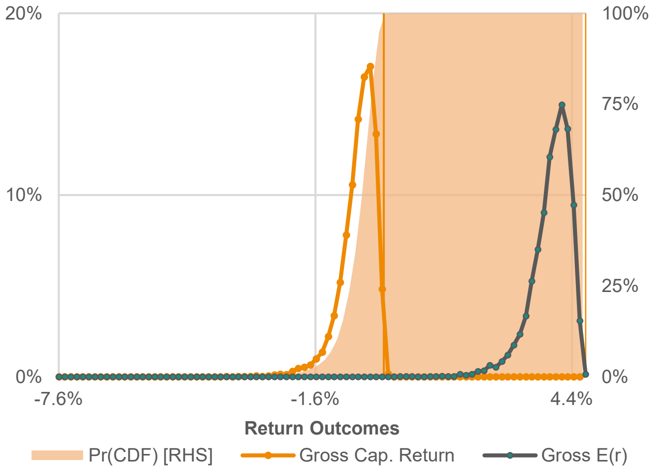
FROM\TO	AAA	AA	A	BBB	BB	B	CCC	Default
AAA	100.0%	3.9%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
AA	0.0%	94.4%	3.8%	0.4%	0.4%	0.4%	0.3%	0.3%
A	0.0%	0.0%	94.0%	4.2%	0.6%	0.5%	0.4%	0.4%
BBB	0.0%	0.0%	0.0%	96.0%	2.2%	0.4%	0.8%	0.5%
BB	0.0%	0.0%	0.0%	0.0%	88.1%	6.3%	3.0%	2.6%
B	0.0%	0.0%	0.0%	0.0%	0.0%	87.9%	7.9%	4.2%
CCC	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	91.3%	8.7%

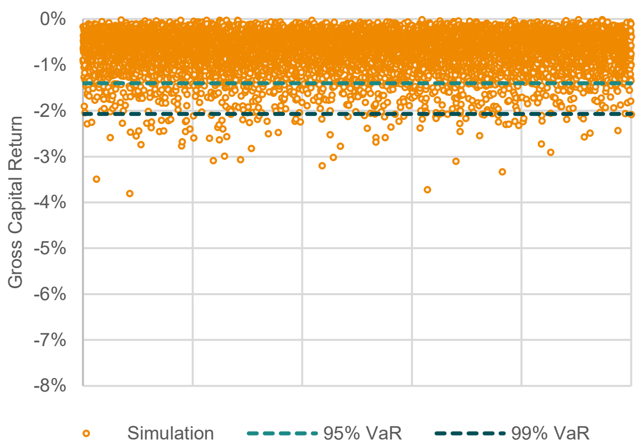
Source: BondAdviser, Moody's
** Adjusted to account for withdrawn ratings and to eliminate probability of an upgrade or upwards revaluation.*

For Scenario 1, **the Fund demonstrates excellent** resilience to adverse credit migrations. This resilience is tested in later scenarios, for which three key attributes remain true. The first is the diversity of the portfolio - on a look through basis, MDIF contains >180 unique borrowers, which mitigates the impact of any single adverse valuation. The second is seniority of the loans, senior secured loans have significantly better LGD outcomes than bonds, this relies on the assumption that previous default outcomes will not materially alter from historical recoveries. The third is regarding adverse mark-to-market revaluations - given the short average tenor (2.2 years), the quantum of cashflows revalued, using a higher discount rate, is lower, mitigating the impact to the portfolio.

Additionally, Scenario 1 benefits from another attribute, which is altered in our alternative scenario to isolate the impact on the portfolio. It is the low probabilities of adverse credit migrations, relative to distressed market conditions, by use of the single-year 2018 statistics – a benign year for credit defaults. Scenario 1 has a mean capital loss (excludes coupon carry, origination fees and management fees) of -0.7% and total capital value-at-risk of -2.1% (again excluding coupon carry and fees, 1% VaR probability).

Scenario 1. Baseline Asset Assessment (Long Term Average Data)





Source: BondAdviser Estimates. Excludes impact of management and origination fees. Gross capital returns exclude the value of coupons/income and is only modelling impairment or loss given default, based on historical credit data from Moody's. Impact of traded price is not simulated.

To test the portfolio under distressed conditions we use migration rates from 2009, the worst year for corporate defaults globally during the GFC. Scenario 2 models against assumptions that are identical to Scenario 1 except for migration probabilities and historical corporate yield curves. As illustrated in Table 3, JTD probabilities increase ~2x for BB rated bond and loan assets, however the probability is still relatively small (5.1%).

The table highlights a material increase in the migration to CCC or JTD probability across all ratings, the impact of which is further amplified by materially lower recovery rates during this time.

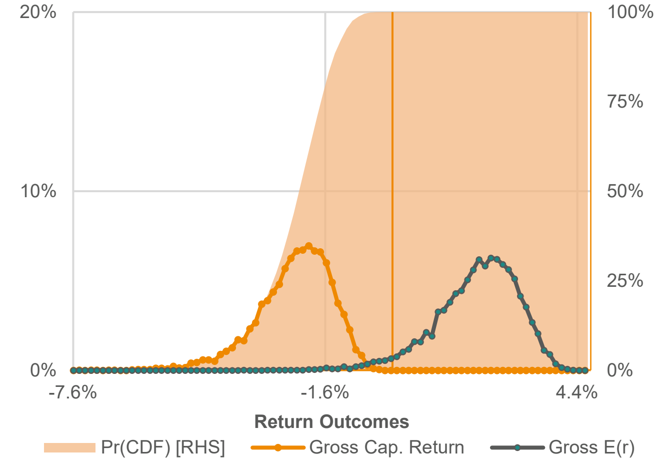
Table 4. Adjusted* GFC Migration Rates (2009)

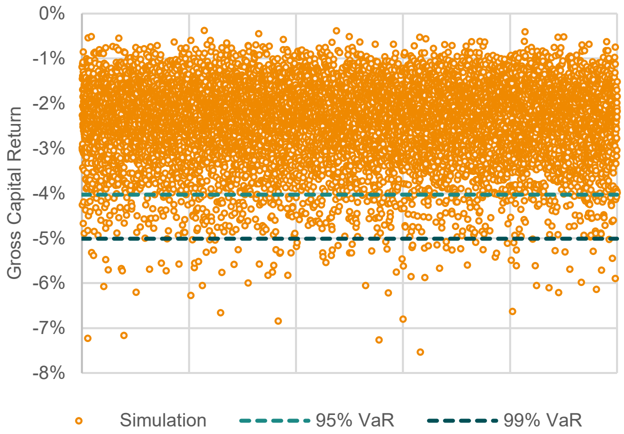
FROM\TO	AAA	AA	A	BBB	BB	B	CCC	Default
AAA	**64.9%**	35.1%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
AA	0.0%	**72.1%**	23.3%	1.9%	0.9%	0.7%	0.7%	0.5%
A	0.0%	0.0%	**82.4%**	13.6%	1.2%	1.3%	0.7%	0.8%
BBB	0.0%	0.0%	0.0%	**89.1%**	6.5%	1.5%	1.3%	1.6%
BB	0.0%	0.0%	0.0%	0.0%	**77.6%**	14.3%	3.1%	5.1%
B	0.0%	0.0%	0.0%	0.0%	0.0%	**74.5%**	15.9%	9.7%
CCC	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	**64.2%**	35.8%

Source: BondAdviser, Moody's
** Adjusted to account for withdrawn ratings and to eliminate probability of an upgrade or upwards revaluation.*

The portfolio's results deteriorate in the stressed assessment, having a mean capital loss of -2.4% and total capital value-at-risk of -5.0% (1% VaR probability). This demonstrates that even with markedly higher chances of default, the Fund continues to perform well through its seniority.

Scenario 2. Stressed Asset Assessment (2009 Data)





Source: BondAdviser Estimates. Excludes impact of management and origination fees. Gross capital returns excludes the value of coupons/income and is only modelling impairment or loss given default, based on historical credit data from Moody's. Impact of traded price is not simulated.

When comparing the scenarios, it is clear that JTD and LGD significantly drive ultimate outcomes of the modelling onto the portfolio. The portfolio performs exceptionally well across all scenarios; however we reiterate this is materially influenced by diversification of underlying borrowers, seniority of the assets (driving stronger LGD outcomes) and a short average remaining term of securities.

We are aware and highlight the many deficiencies of our approach, not least that:

- Private lending is not identical and has different default paths and outcomes to rated corporates.
- It does not consider the additional protections implemented by Metrics to mitigate credit migration or default risks, nor account for the restructuring capabilities of Metrics in the event of distress or default.
- Our modelling contains assumptions, several of which are subjective and have material output impacts.

The quantitative framework defines the forward-looking risk score for our overall product assessment of the Fund. This is consistent with the BondAdviser Fund Research Methodology and overlays an objective evaluation to our recommendation. Based on our analysis, **we assign the Fund a risk score of 'A'** or 'Lower Medium'. This is superior to the weighted average credit profile. This is due to an effective upward notching in relation to diversification of underlying counterparties.

This risk assessment does not account for the previously mentioned expertise of Metrics in avoiding defaults and instead assumes that assets would be held to default, without stipulating any restructuring activities. In reality, borrowers are actively researched, followed and subjected to many levels of scrutiny and oversight. We expect that, in-line with demonstrated history, assets would be managed prior to such an event occurring. Considering all the above, we are comfortable with Metrics ability to avoid significant credit losses whilst delivering consistent income.

Research Methodology

Overview

At BondAdviser, our focus is on delivering the highest quality data, research and insights so that investors can make intelligent decisions about the fixed income market. At the centre of our approach is a proprietary 5-pillar process for analysing fixed income funds in a rigorous and disciplined manner. Our approach results in a recommendation scale that investors can readily use to identify the most attractive investment opportunities.

Our ability to provide a clear and concise investment recommendation from the very diverse and unique fixed income portfolios and funds within our coverage universe is a key benefit of our research process. We simplify an otherwise complex procedure for investors into a simple, recognisable and consistent recommendation scale.

We use a bespoke combination of qualitative assessments and forward-looking quantitative analysis. In our experience, most other research is backwards looking, which naturally limits its usefulness. By combining our deep understanding of fixed income markets and their emergent trends with our extensive modelling and forecasting capabilities, we aim to solve this limitation and output meaningful, risk-adjusted prospective recommendations for investors.

Research Approach

BondAdviser has adopted a multi-pillar, risk-based approach to the assessment of funds. In our opinion, an investor's exposure to credit risk is not uniform and can be well mitigated by manager skill, experience and supporting governance structures. We identify 5 key pillars of credit risk mitigation and these then form sections of analysis in our reports:

- Investment Objectives, Strategy and Performance
- Portfolio Construction and Investment Process
- Liquidity, Operating & Financial Risk Management
- Governance, Asset Stewardship and Compliance
- Quantitative Analysis

Research Process

The initial screening of funds and assets is based on a globally recognised best practices approach to alternative assets as defined by the Alternative Investment Managers Association (AIMA) and risk management as identified by the International Organisation of Securities Commissions (IOSCO).

All assets and managers must meet minimum requirements as outlined in our initial due diligence questionnaires. Detailed interviews, operational checks, process documentation and data collection then follow. Each of these steps helps to ensure that our recommendations are consistent and are based on a comprehensive understanding of the key drivers of the underlying market segment and asset class(es), the investment manager and broader portfolio.

Classification

We broadly adhere with international and Australian accounting standards and global best practice in designating assets according to their place in the fair value hierarchy defined in International Financial Reporting Standard 13 (IFRS13) - Fair Value Measurement (Australian version – AASB 13). All assets designated as "Credit" fall under three categories based on market observability as outlined below:

- **Level 1 (Active Markets)** - assets that have quoted prices in active markets, providing the most reliable evidence of fair value. As a result, transactions for these assets can generally occur at this price as at the measurement date. Domestically, typical examples of Level 1 assets include Australian Government Commonwealth bonds, listed debt and hybrid instruments and RBA repo-eligible financial instruments.

• **Level 2 (Non-Active Markets)** - assets that have observable prices (directly or indirectly), not included within the Level 1 category (i.e. not quoted on an exchange). Assets referencing credit spreads and interest rates would qualify if the input is observable for the full tenor. This category generally encompasses credit markets which have limited secondary market activity such as corporate bonds, subordinated debt and syndicated loans.

• **Level 3 (Illiquid and Alternative Credit)** – assets that have mostly unobservable inputs and hence valuation models are used, driven in part by assumptions and expectations. There may be an independent overlay and a model risk adjustment to derive an exit (market) price. A limited secondary market is typical and these assets are often referred to as alternative credit. Examples of this segment include "structured" credits such as RMBS, CMBS, ABS and private debt investing.

Product Assessment

The BondAdviser Product Assessment is the culmination of our research process applied to our pillar-based research approach. We conclude whether a fund is screened-out, approved, recommended or highly recommended as broadly defined below:

• **Screened Out** – The fund does not (or no longer) satisfies our minimum criteria for research inclusion.

• **Approved** – Our research allows us to conclude that the fund manager, governance structure, policies and procedures appear to be sound and capable of managing the fund adequately to target its benchmark.

• **Recommended** – We have a reasonable expectation that the fund will achieve its target benchmark.

• **Highly Recommended** – We believe that superior skills, systems and processes mean that the fund has a high likelihood of meeting and probably exceeding its benchmark target. Note that we only Highly Recommended assessments after issuing multiple reports over an extended period of time

Risk Score

Our Risk Score is aligned to the same methodology that is utilised in BondAdviser's single-instrument reports. It is not a credit rating and should not be used as such.

• AAA – Very Low

• AA – Low

• A – Lower Medium

• BBB – Upper Medium

• BB – High

• B – Very High

• CCC – Extreme

• D – Default (Fund Closed)

Our overall Risk Score is driven by the underlying credits of a fund coupled with our quantitative analysis. It is mutually exclusive to the Product Assessment. For example, it is possible for a fund to be Highly Recommended and have a risk score of CCC. This could occur where the fund invests in riskier credit assets but we are very confident of its capability to meet or exceed its benchmark target. Conversely, a fund comprising mostly of government bonds may hold a Risk Score of AAA but its governance processes, history and controls are not as strong as peers and warrant only an Approved assessment.

Important Information

BondAdviser has acted on information provided to it and our research is subject to change based on legal offering documents. This research is for informational purposes only. This information discusses general market activity, industry or sector trends, or other broad-based economic, market or political conditions and should not be construed as research or investment advice.

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Report created on 24 August 2021.