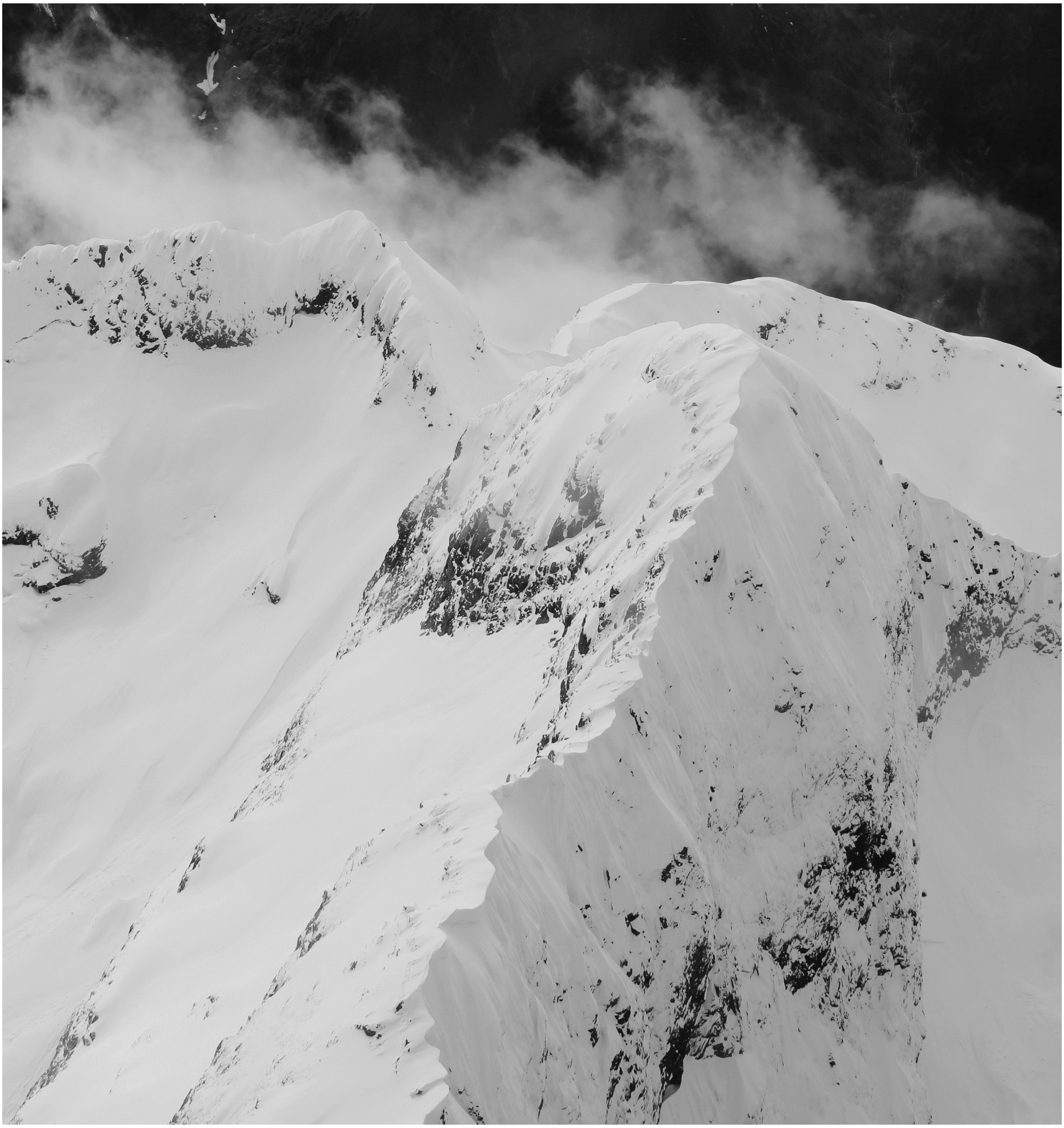
Fund Research

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 with exposure to the Australian corporate loan market. This sub asset-class is an important part of the Australian corporate debt market that has previously been restricted to major banks and institutional investors. For this reason, MDIF offers retail investors a unique investment opportunity and exposure to a market not readily directly accessible to them.

Metrics has a similar fund to MDIF that is listed on the ASX in the “Metrics Master Income Trust” (ASX: MXT) which listed in October 2017. MDIF is a solution for investors that want redemption certainty (with respect to NAV - as compared to the unit price of MXT). The Fund is also beneficial to investors who want the exposure to the underlying portfolio of MXT without explicit unit price risk (although the Fund may choose to hold MXT, resulting in minor implicit unit price risk).

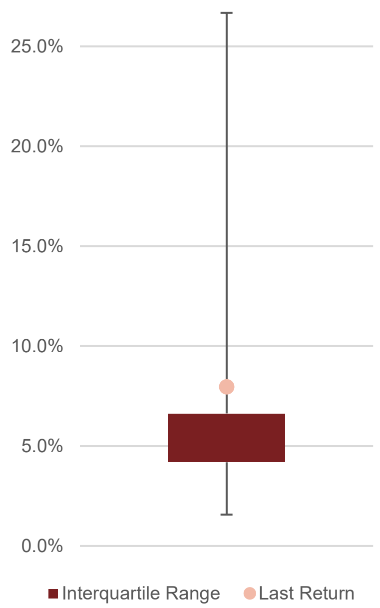
The Trust’s investment objective is to provide private stable capital value and attractive income with a target return of the **RBA cash rate plus 3.25% p.a**. (currently 6.10% p.a.) **after fees**, payable monthly. The Fund invests in Metrics funds via the Wholesale Investment Trust (WIT), which, in turn, invests in Metrics wholesale institutional investor funds that participate across the credit risk spectrum and are managed by Metrics Credit Partners Pty Ltd (Metrics). Both MDIF and MXT invest in the WIT, however, MDIF also has the ability to invest in units of MXT.

Figure 1. Monthly Net Returns* (%)

	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	YTD
2022	0.27	0.36	0.35	0.35	0.40	0.48	0.47	0.55	0.53	0.64			**4.40**
2021	0.13	0.43	0.72	0.24	0.77	0.42	0.37	0.44	0.25	0.47	0.25	0.47	**4.95**
2020							1.99	1.19	0.28	0.35	0.32	0.77	**4.90**

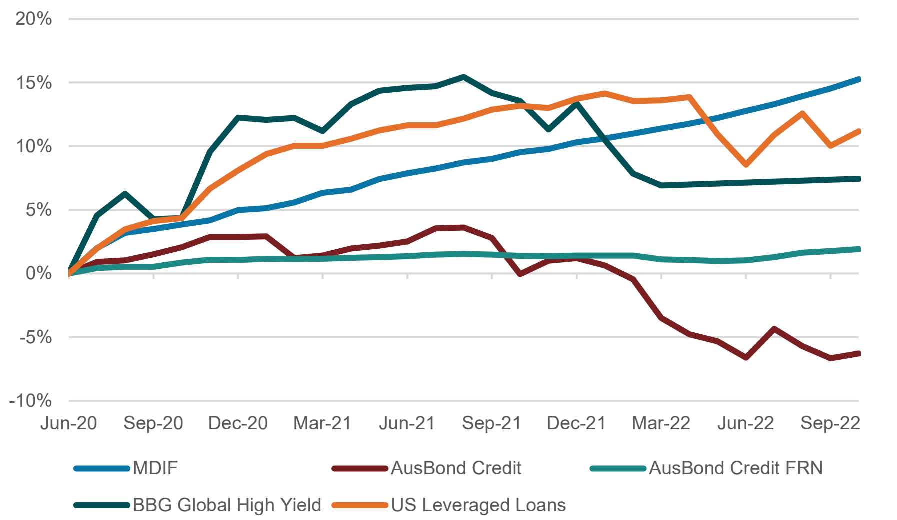
Source: BondAdviser, Metrics. As at 31 October 2022. May not sum due to rounding.
** Return is monthly net total return based on NTA plus dividends.*

Figure 2. Monthly Net Returns Box Plot



Source: BondAdviser, Metrics. Annualised monthly returns, after fees since inception.

Figure 3. Relative Cumulative Performance



Source: BondAdviser, Metrics, Bloomberg. As at 31 October 2022. Calculated from cumulative net monthly returns of the Underlying Fund. Returns on NAV, not traded unit price, see Figure 12 for MXT unit price variance.

Product Assessment

Highly Recommended

MDIF provides retail investors with exposure to the domestic corporate loan market, providing diversification benefits for investors holding traditional fixed income and equity securities.

MDIF provides retail investors with unique exposure to the domestic commercial lending market. 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 the MCP Wholesale Investment Trust (WIT) along with the capability to invest in Metrics Master Income Trust (ASX: MXT). MXT exclusively invests in the WIT.

The Fund is beneficial for investors who want to reduce explicit unit price risk. During times of market distress (which has been prevalent during 2022), exchange-traded funds often experience dislocation between the NAV of the Fund and its unit price. The Fund is exposed to implicit risk in the fluctuation of the unit price of MXT, although MDIF would likely capture the appreciation of the unit price of MXT where it trades irrationally far from its NAV.

MDIF is suitable for investors who **seek low capital volatility** and an **attractive income stream** through an **actively managed diversified portfolio of domestic private loans.** Though the asset class is relatively immature in the domestic market, the product exhibits low correlations with traditional asset classes, providing diversification benefits through the cycle for investors primarily holding traditional fixed income and equity securities.

The underlying Fund continues to grow the number of unique borrowers, mitigating counterparty risk on an individual loan basis. Combined with the majority of positions being senior secured, our modelling estimates show protection against potential downside scenarios.

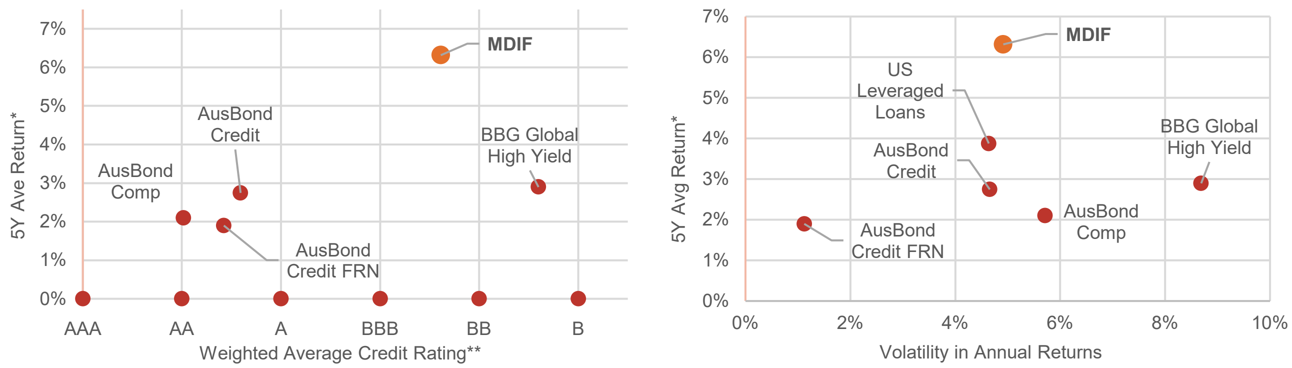
MDIF continues to perform well, consistently exceeding its target. On a rolling 12-month basis to 31 October 2022, MDIF has returned 5.24% (net) and generated a net annualised return of 6.27% since inception in July 2020. With interest rates rapidly accelerating, risks are growing for lenders. We remain confident in Metrics' ability to originate and structure credit, and diligently monitor performance to mitigate risk at the individual loan and portfolio level, given the depth and experience of its investment team in combination with robust systems and processes in place.

Importantly, we note the benefits of the structural seniority of loans and counterparty diversification in the portfolio. On an individual loan level, risk is reduced with around 90% of the underlying portfolio (excluding cash) invested in senior secured loans, improving the outcome in recovery in the event of default of a borrower. At the portfolio level, risk is mitigated by the diversification benefits of having ~300 unique counterparties. Interest rate (duration) risk is negligible (~0.1 years), with 97% of the underlying portfolio invested in floating rate loans as at 30 September 2022. Although rising interest rates provides rising income to investors, on the contrary, this implies that the borrower faces rising interest payments. On this basis, this weakens debt serviceability for credits within the Fund – this is a market wide dynamic that is not isolated to Metrics.

The underlying portfolio holds a material amount of real estate exposure (~50.0% on a commitment basis), which we are cautious of given the recent headwinds (rising material costs and interest payments) faced across the sector. We are comforted by the fact that ~48.5% of the total 50.0% portfolio exposure to real estate is senior secured, improving the outcomes of recovery in the event of default. Further, Metrics has a proven record of diligently originating and structuring Commercial Real Estate (CRE) investments, focusing on lending against projects. Notably, Metrics does not lend to building contractors and none of Rallen, Metricon, Probuild, Grocon, Next, Cayden or ConDev were either borrowers or contractors on developments sites Metrics finance. We note that in the event of a historically unprecedented downturn in real estate, the heavily subordinated/equity tranches would be first in line for losses, whereas the underlying loans in the Fund are typically situated higher up in the capital structure shielded from first losses.

MDIF on a standalone basis would have a product assessment of Recommended. However, with MXT carrying a Highly Recommended assessment, MDIF qualifies for a chiral assessment. Accordingly, we maintain our rare top-tier **Highly Recommended** product assessment for MDIF. This rare upward notching is a function of: (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.

Figure 4. Estimated Risk-Adjusted Return Comparison



** All returns for indices calculated using annualised monthly returns for the past five years. Average return for MDIF calculated since inception in July 2020.*
*** Credit Ratings based on BondAdviser Estimates. *** Calculated based on annualised monthly returns data for past five years for indices and since inception for MDIF. Source: BondAdviser, Metrics, Bloomberg as at 30 September 2022.*

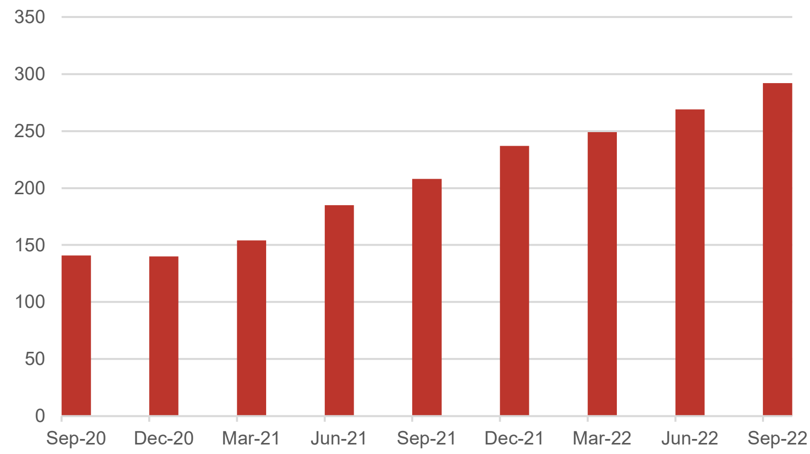
Construction and Investment Process

There have been **no material changes** to MDIF's construction and investment process.

Portfolio Risk Management

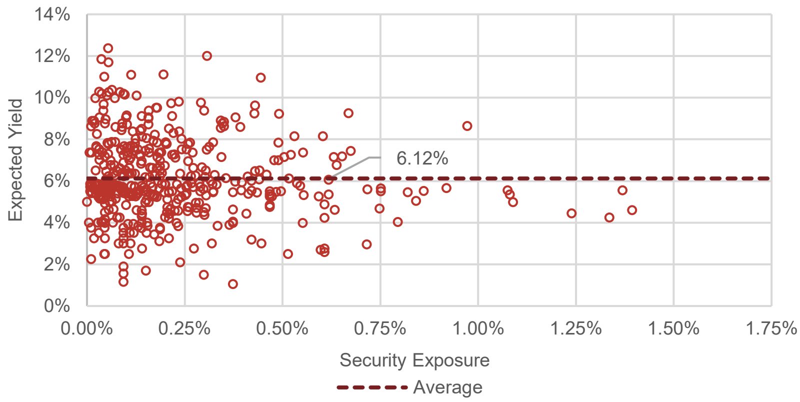
The Fund's underlying portfolio deployed its cash holdings to 0.7% (June: 6.7%), to which a higher allocation was made over the quarter to BBB (48.0% from 45.2%) and BB rated (40.0% from 37.3%) securities. As a result, the weighted average credit rating was immaterially lower against the previous quarter. The underlying portfolio continues to increase the number of unique counterparties (292 total as at 30 September), further providing mitigation against counterparty risk. The largest single loan exposure rose from 1.65% to 1.87% (excluding cash, on a commitment basis) as at 30 September, albeit this is still a very low single counterparty exposure. The average loan exposure edged 2bps lower over the quarter to 22bps. The underlying Fund exhibits strong diversification across single credit exposures, which is positive for private credit funds due to the asymmetric payoff of loans – somewhat offsetting this is potentially correlated exposure in real estate lending, which is 50% of the portfolio. Mitigating counterparty and sector risk is critical, especially pertinent more so now as the operating environment becomes tighter.

Figure 5. Unique Borrower Exposure Over Time



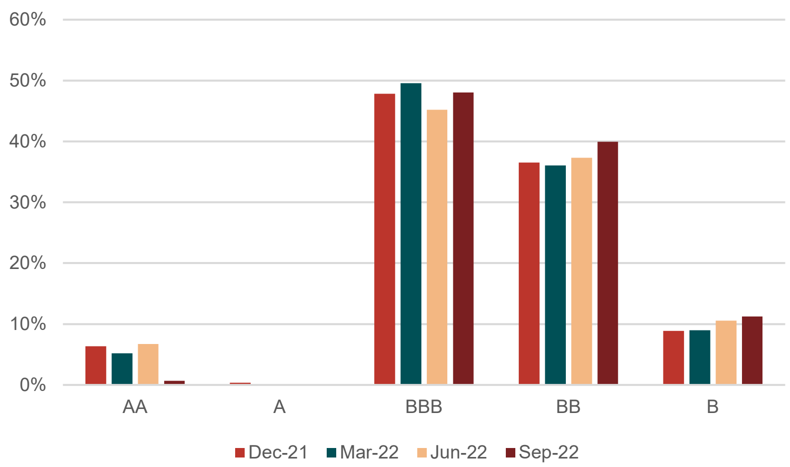
Source: BondAdviser, Metrics. As at 30 September 2022. Based on Metrics' underlying portfolio (WIT) not MDIF.

Figure 6. Individual Loan Exposure vs Expected Yield*



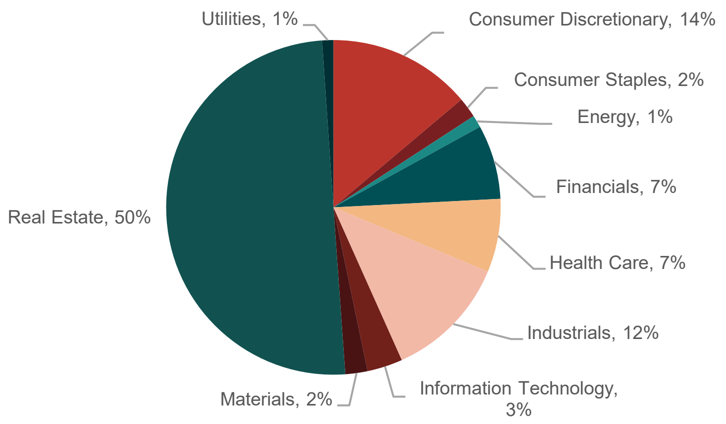
*Source: BondAdviser, Metrics. As at 30 September 2022. *Excluding cash . Based on Metrics' underlying portfolio (WIT) not MDIF.*

Figure 7. Portfolio Credit Rating Mix*



*Source: BondAdviser, Metrics. As at 30 September 2022 *Including cash which is rated AA. Based on Metrics' underlying portfolio (WIT) not MDIF.*

Figure 8. Portfolio Exposure by S&P Sector*

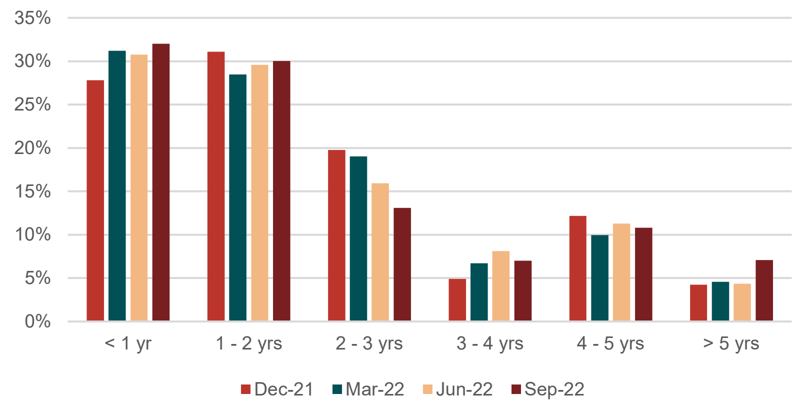


*Source: BondAdviser, Metrics. As at 30 September 2022. *Excluding cash. Based on Metrics' underlying portfolio (WIT) not MDIF.*

Figure 9. Individual Loan Exposure*

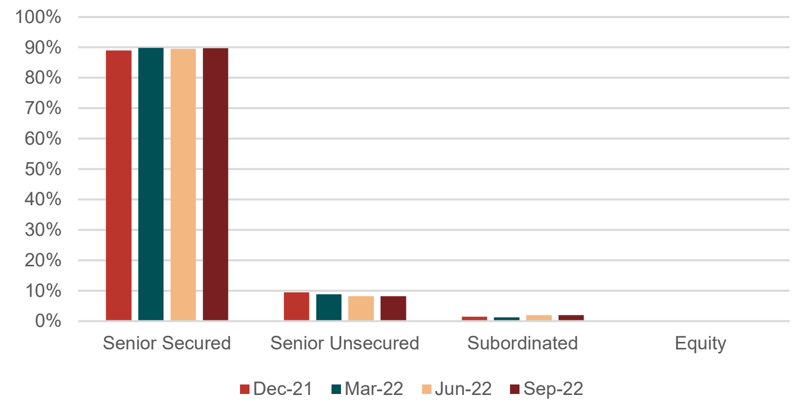
*Source: BondAdviser, Metrics. As at 30 September 2022. *Excluding cash. Based on Metrics' underlying portfolio (WIT) not MDIF.*

Figure 10. Portfolio Loan Tenor Mix*



*Source: BondAdviser, Metrics. As at 30 September 2022. *Excluding cash. Based on Metrics' underlying portfolio (WIT) not MDIF.*

Figure 11. Portfolio Seniority Mix*

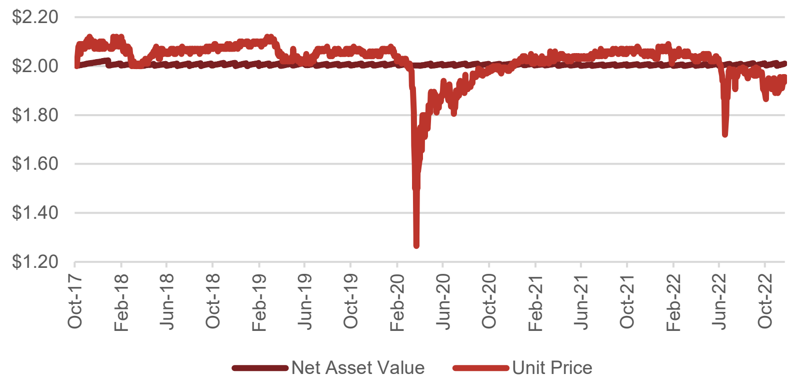


*Source: BondAdviser, Metrics. As at 30 September 2022 *Excluding cash. Based on Metrics' underlying portfolio (WIT) not MDIF.*

Fund Governance

There have been **no material changes** to MDIF's fund governance.

Figure 12. MXT Net Asset Value Against Unit Price



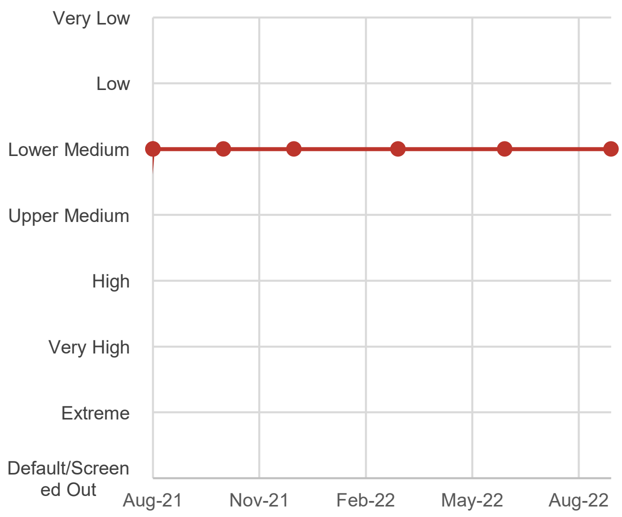
Source: BondAdviser, Metrics, Bloomberg. As at 22 November 2022.

MDIF has the ability to invest in WIT or directly in units of Metric's retail fund, MXT. As at 30 September 2022, MDIF has allocated 9.1% into MXT. Whilst this implicitly exposes the Fund to unit price fluctuation, the ability to purchase units of MXT at a steep discount to NAV would allow MDIF to take advantage of unit price appreciation as the unit price of MXT approaches its NAV. The dislocation occurring in June narrowed from ~14% to 2.8% as of 22 November 2022, which can provide another (albeit minor) source of return to MDIF investors through active management.

The structure of the Trust has not changed and is outlined in a prior report (see page 14 of MDIF Initiation Report - 24 August 2021).

Quantitative Analysis

Figure 13. Risk Score

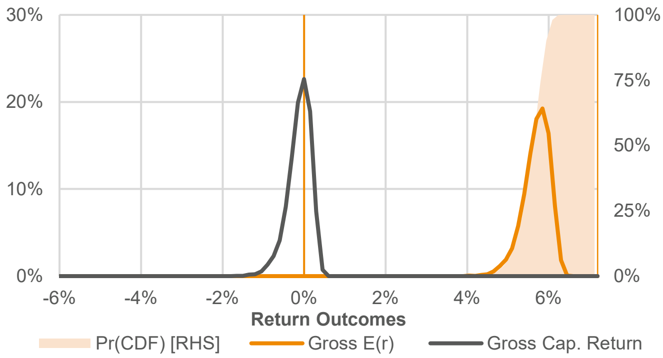


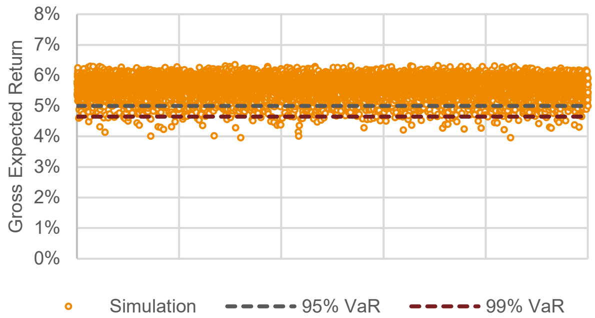
Across both the baseline and stressed scenarios, our modelling continues to demonstrate strong portfolio performance, offering attractive risk-adjusted returns, as well as downside protection in distressed scenarios. Over the course of 2022, simulated portfolio returns in our baseline scenario have continually improved each quarter as a result of reference rates resetting higher, benefitting the portfolio given its high proportion of floating-rate holdings. This has driven noticeably stronger performance under the both scenarios with the 99% VaR in a GFC-like environment now at 2.85%, up significantly from 0.87% at 31 March 2022.

Furthermore, the Fund continues to decrease counterparty risk, as the number of unique borrowers has steadily grown to over 290. This focus on diversification, coupled with a steady, high proportion (~90%) of senior secured holdings, has driven lower LGD outcomes, and subsequently, better performance in the downside scenario.

Our risk score remains at "Lower Medium", which is a notch above the weighted average credit profile, reflecting the Fund's strong credit profile, diversification, and performance under stressed conditions.

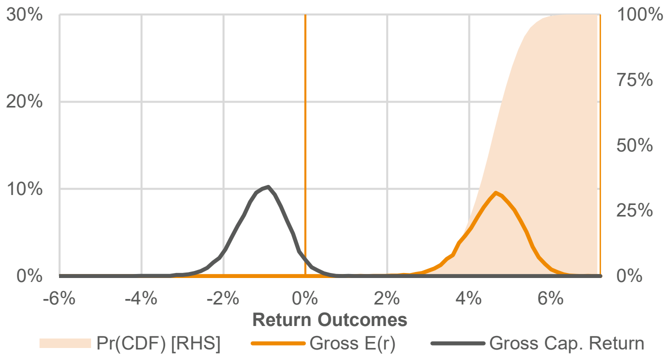
Scenario 1. Baseline Asset Assessment

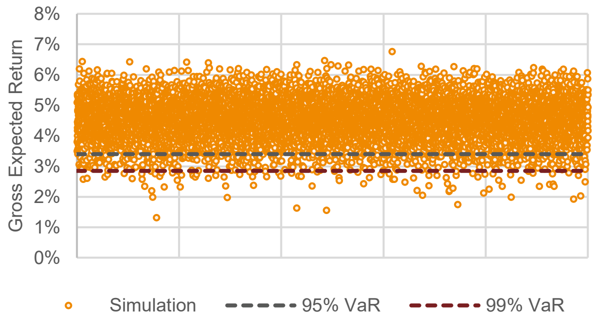




Source: BondAdviser Estimates as of 30 September 2022 portfolio. Excludes impact of management and origination fees. Gross capital returns excludes the value of coupons/income and is only modelling impairment or loss given default, based on historical credit data from Moody's. Impact of traded price is not simulated. For a more detailed explanation of the methodology, please contact BondAdviser.

Scenario 2. Stressed Asset Assessment





Source: BondAdviser Estimates as of 30 September 2022 portfolio. 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.

Reporting History

MDIF Update Report – 17 October 2022

MDIF Update Report – 26 May 2022

MDIF Update Report – 27 April 2022

MDIF Update Report - 5 November 2021

MDIF IPO Report – August 2021

Alternative Investment Fund Research Methodology

Click here to view

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Report created on 7 December 2022.