Fund Research

Metrics Direct Income Fund

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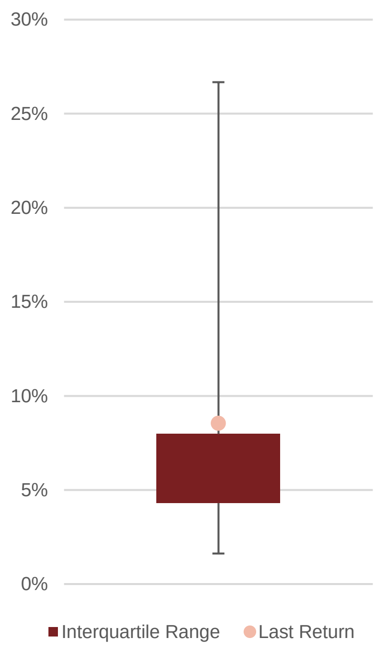
Overview

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. MDIF gains such exposure across the credit risk spectrum via investment in wholesale funds managed by Metrics. This sub asset class is a valuable 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 in a market not readily directly accessible to them.

Metrics Credit Partners Pty Ltd (MCP, Metrics) also has a similar fund to MDIF that is listed on the ASX in the "Metrics Master Income Trust" (ASX: MXT), which listed on the ASX in October 2017. MDIF is an alternative investment vehicle for investors that want greater redemption certainty (with respect to NAV - as compared to the unit price of MXT), while still providing exposure to the same underlying portfolio as MXT. MDIF avoids explicit unit price risk, however the Fund may choose to hold MXT units, which brings minor implicit unit price risk. This feature does require investor consideration as in times when the MXT share price is dislocated from its NAV, while MDIF's opportunistic investment in MXT would support the share price in returning to NAV, such support may be insufficient in the face of market-wide selling. This can somewhat undo the benefits of being an unlisted fund.

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 7.35% p.a.) **after fees**, payable monthly. The Fund invests in the MCP 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. 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 Box Plot



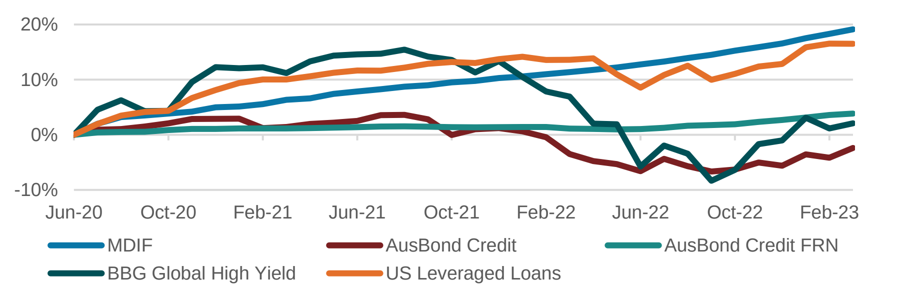
Source: BondAdviser, Metrics. Annualised monthly returns, after fees since inception.

Figure 2. Monthly Net Returns* (%)

	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	YTD
2023	0.81	0.68	0.69										**2.18**
2022	0.27	0.36	0.35	0.35	0.40	0.48	0.47	0.55	0.53	0.64	0.55	0.59	**5.55**
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 March 2023. May not sum due to rounding.
** Return is monthly net total return based on NTA plus dividends.*

Figure 3. Relative Cumulative Performance



Source: BondAdviser, Metrics, Bloomberg. As at 31 March 2023. Calculated from cumulative net monthly returns of the Underlying Fund. Returns on NAV, not traded unit price, see Figure 11 for MXT unit price variance.

Product Assessment

Highly Recommended

MDIF offers a relatively market-insulated alternative to MXT with greater liquidity certainty while investing in the same underlying portfolio.

MDIF provides retail investors with exposure to the domestic commercial lending market. On an underlying basis, the Fund predominantly comprises senior secured, floating rate loans to investment grade and sub-investment grade companies. It is an unlisted, open-ended Fund with said exposure obtained by primarily investing 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 WIT is comprised of three wholesale Funds that Metrics manage, the MCP Diversified Australian Senior Loan Fund (DASLF), the MCP Secured Private Debt Fund II (SPDF II) and the MCP Real Estate Debt Fund (REDF). The respective split across these funds is approximately 60/20/20 with the allocation at Metrics' discretion within the following bands: DASLF 60-70%, SPDF II 20-30%, and REDF 10-20%.

The Fund is best suited for investors seeking low capital volatility plus an attractive, monthly income stream from an actively managed diversified portfolio of domestic private credit. The product also provides diversification benefits to investor portfolios given low correlations of private debt to traditional asset classes such as equities and fixed interest.

The Fund Manager's opportunity set is currently elevated as a function of general bank risk aversion, providing for an attractive redeployment pipeline of select risk-adjusted investment opportunities.

MDIF continues to consistently outperform its returns target. On a rolling 24-month basis to 31 March 2023, MDIF returned 5.84% p.a. (net assuming reinvestment of distributions) and generated a net annualised return of 6.58% since inception in July 2020. The benchmark of RBA Cash Rate + 3.25% has returned 4.32% p.a. and 4.05% p.a. over the same respective periods.

Being unlisted, MDIF should be relatively immune to unit price volatility that listed funds can experience in times of market distress, as seen during the onset of the pandemic in early-to-mid 2020 and more recently the broad-based market sell-off in June 2022, which both resulted in a dislocation between listed funds' unit price and NAV. On 28 August 2023, after ~14 months of bifurcation, the MXT unit price returned to trading at or above NAV and has done for 36 of the past 39 trading days (0.5% premium to NAV at 20 October 2023).

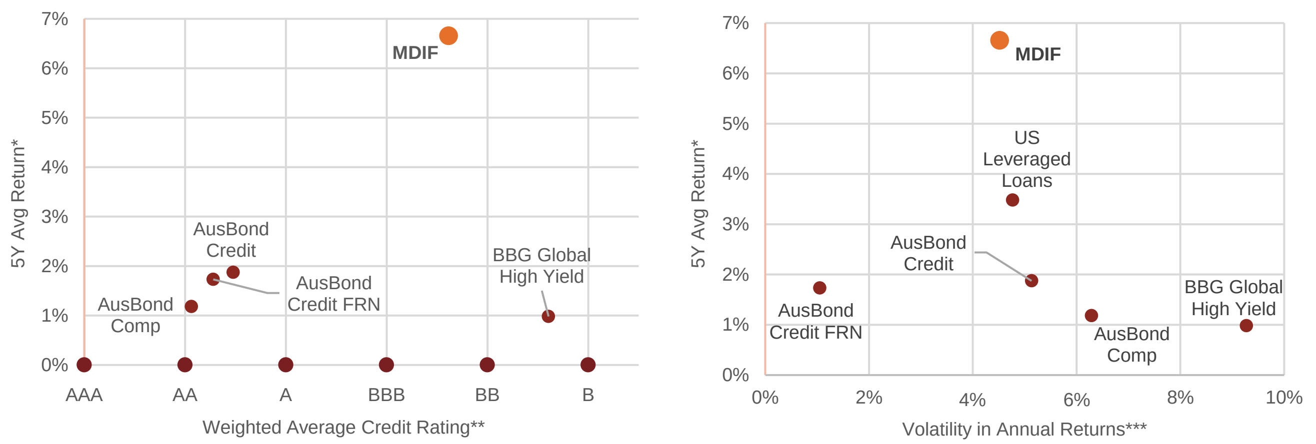
All lenders are subject to rising credit risks given the inflationary environment along with the spike in interest rates. We are particularly wary at this point in the credit cycle of the underlying portfolio's ~54% exposure to real estate (on a commitment basis) – noting that almost 20% is exposed to real estate development. Positively offsetting some of this concern is ~97% of the real estate loans in the underlying portfolio are ranked senior secured as at 31 March 2023. Such positioning protects against first losses that are worn by subordinated/equity tranches in the borrower's capital structure. We also note that Metrics has established a commendable track record of originating, structuring, and managing commercial real estate credit investments. It is important to observe that the Fund does not lend to building contractors.

As a function of the turning credit cycle, the manager is finding a growing opportunity set as the banks tighten their lending policies. This is resulting in borrowers that were previously of high enough quality for bank funding being forced to look elsewhere for capital. Metrics now has a greater pipeline than at other points in the cycle and is able to be increasingly selective in capital allocation to the best risk-adjusted return opportunities.

While there is the occasional tardiness of a few days as is usual for most private credit portfolios, there continues to be zero loans in arrears of 30 days or greater, reflecting the quality of Metrics' book. Given the relatively large number of counterparties Metrics lends to, we view this as a function of careful screening processes to gain comfort before precise funds deployment. Metrics both has robust systems and processes to originate and structure loans, as well as diligent performance monitoring procedures to mitigate credit risk at the individual loan and portfolio level. At the portfolio level, concentration risk is reduced by the diversification benefits of having a number of unique loan counterparties that totaled 306 as at 31 March 2023. At the loan level, the risk of losses in an event of default is lessened with around 91% of the underlying portfolio (excluding cash) invested in senior secured loans, which improves the potential recovery following a loan default event.

Independently, MDIF would be eligible for a Recommended product assessment based on its own merits. However, it receives an unusual upward adjustment due to the following factors: (1) BondAdviser's separate evaluation of the underlying funds; (2) these funds have consistently outperformed their target returns over the last two years; and (3) MDIF's does not require FX hedging into the WIT or MXT. As a result, since MXT holds a Highly Recommended rating, MDIF qualifies for a symmetrical evaluation. Thus, we uphold our uncommonly issued top-tier product assessment of **Highly Recommended** for MDIF.

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 31 March 2023.

Construction and Investment Process

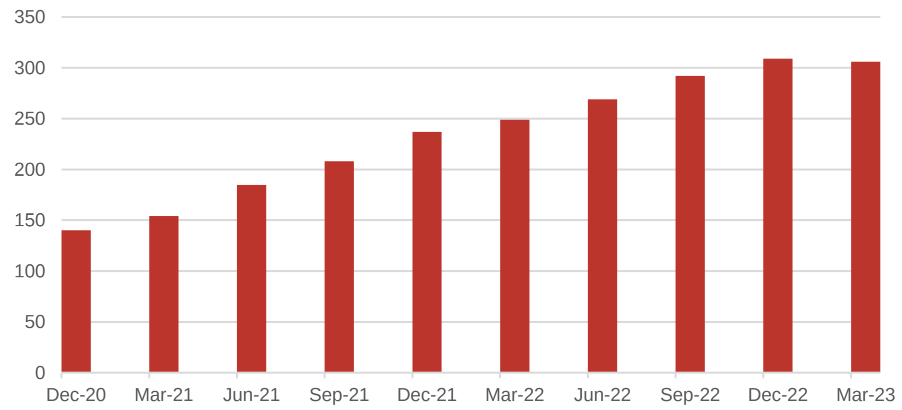
There have been **no material changes** to MDIF's construction and investment process.

Portfolio Risk Management

The risk profile of the underlying portfolio (excluding cash, on a commitment basis) deteriorated moderately over the March 2023 quarter. The allocation to investment grade credit reduced from 50.1% as at 31 December 2022 to 48.9% and is mildly negative. Compared to a year ago, it is 3.5 percentage points lower, which is notable at this point of the credit cycle.

Concentration risk is a key risk for a credit fund and in this regard, we positively note the large number of counterparties in the portfolio as a feature of the Fund from a portfolio credit perspective. Over the quarter, counterparty risk was broadly stable - the number of unique borrowers decreased slightly from 309 to 306, while the average loan exposure rose 1 basis point to 22bps and the largest single loan exposure fell from 1.94% to 1.87%.

Figure 5. Unique Borrower Exposure Over Time

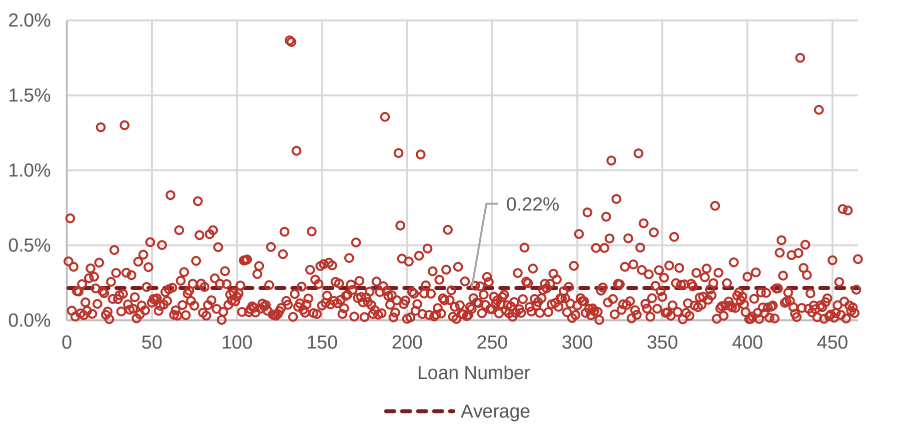


Source: BondAdviser, Metrics. As at 31 March 2023. Based on Metrics' underlying portfolio (WIT) not MDIF.

Of some concern is the uptick in portion of the book that is maturing in less than a year from 31.9% at 31-Dec-22 to 38.2% at 31-Mar-23. Two years ago this portion was just 25.7% of the portfolio. This heightened roll-off places significant pressure on the investment team's ability to originate new loans in order to prevent cash stockpiling and dragging on returns. Such an effect would stand out in this high yielding environment, placing even more pressure on redeployment. While cash drag is bad, rushed investment into weaker credits at this point in the cycle would be far worse. Positively, we are yet to see a material weakening in the portfolio's seniority composition. Additionally, Metrics have proven their ability to successfully and efficiently recycle capital over a number of years, avoiding impact to the portfolio's credit profile or returns. Despite the larger than typical refinancing task ahead, we expect Metrics' record in this regard to continue given there is no shortage of corporate lending opportunities currently.

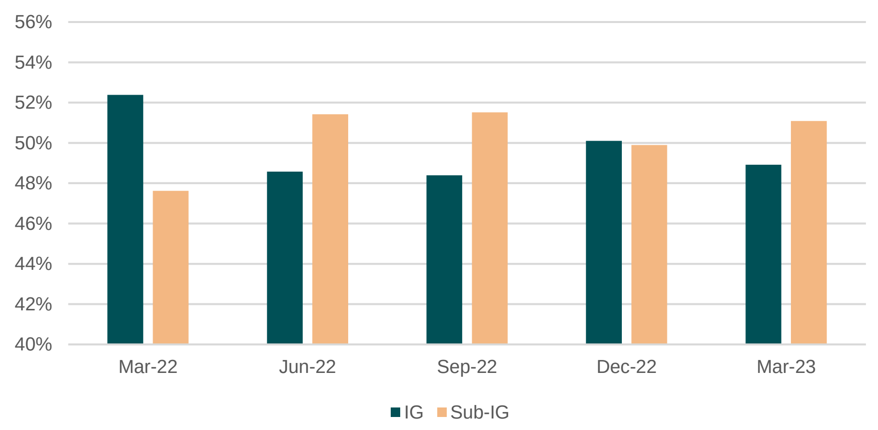
Furthermore, of additional concern is the increasing exposure (excluding cash on a commitment basis) to real estate over the past six months to 54.3% at Mar-23 from 50.0% at Sep-22. About a third of this is exposed to real estate developments with the balance in REITs. This is not a major deterioration, however, is of note as asset cross-correlations are a vital aspect of credit portfolios.

Figure 6. Individual Loan Exposure*



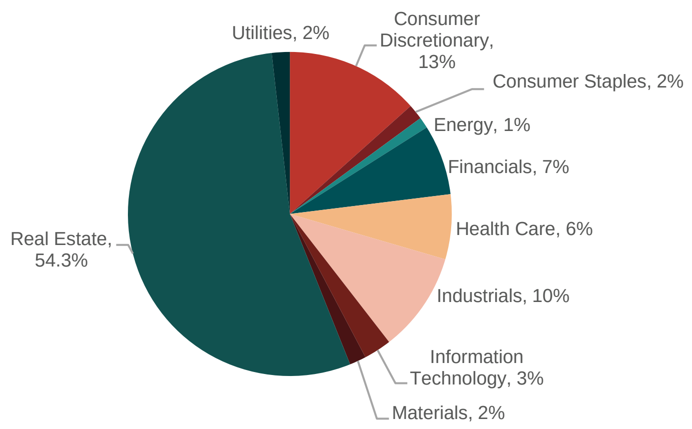
*Source: BondAdviser, Metrics. As at 31 March 2023. *Excluding cash. Based on Metrics' underlying portfolio (WIT) not MDIF.*

Figure 7. Portfolio Credit Rating Mix*



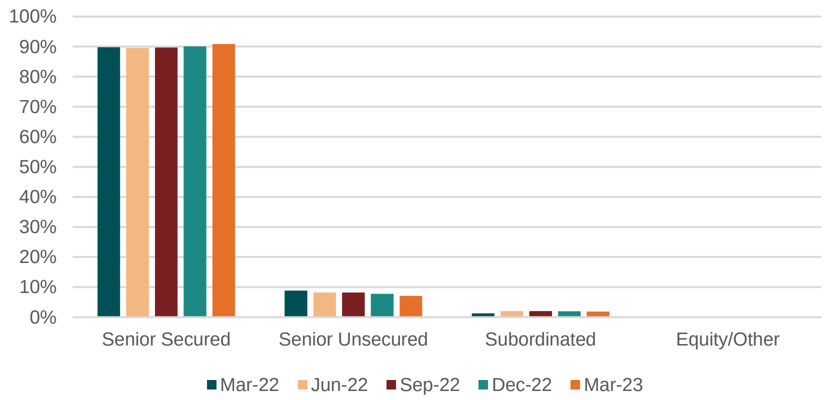
*Source: BondAdviser, Metrics. As at 31 March 2023. * Excluding cash. Based on Metrics' underlying portfolio (WIT) not MDIF.*

Figure 8. Portfolio Exposure by S&P Sector*



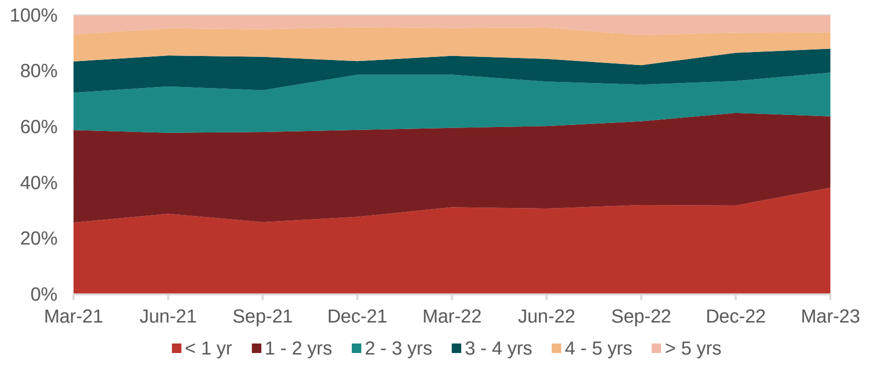
*Source: BondAdviser, Metrics. As at 31 March 2023. *Excluding cash. Based on Metrics' underlying portfolio (WIT) not MDIF.*

Figure 9. Portfolio Seniority Mix*



*Source: BondAdviser, Metrics. As at 31 March 2023. *Excluding cash. Based on Metrics' underlying portfolio (WIT) not MDIF.*

Figure 10. Portfolio Loan Tenor Mix*

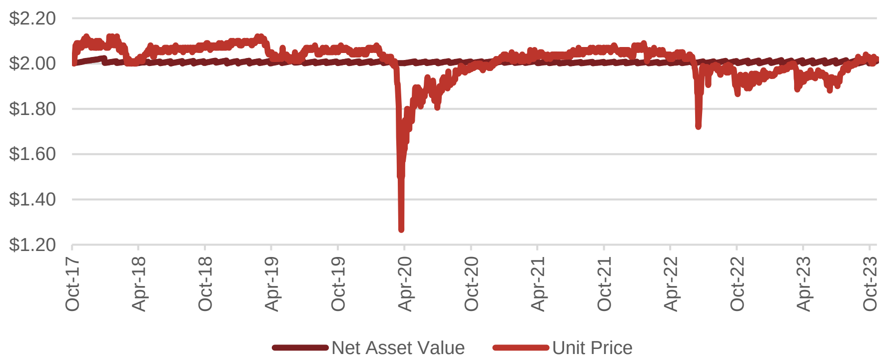


*Source: BondAdviser, Metrics. As at 31 March 2023. *Excluding cash. Based on Metrics' underlying portfolio (WIT) not MDIF.*

Fund Governance

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

Figure 11. MXT Net Asset Value Against Unit Price



Source: BondAdviser, Metrics, Bloomberg. As at 20 October 2023.

MDIF has the ability to invest in the WIT or directly in units of Metric's ASX-listed fund, MXT. As at 31 March 2023, MDIF has allocated 7.7% into MXT, implicitly exposing the unlisted fund to listed market fluctuations. Although this is a risk that typical unlisted fund investors actively seek to avoid, such market movements present an opportunity for MDIF. MDIF can acquire units of MXT at a steep discount to NAV (such as in June 2022 when the discount was around 14%) and benefit from any unit price appreciation as the unit price of MXT approaches its NAV. The discount gap was closed after ~14 months on 28 August 2023 and MXT most recently traded at a 0.5% premium to NAV (20 October 2023 close).

While this has not been the case for MDIF recently, we do stress that markets can be irrational and there are a number of listed investment trusts similar to MXT that have traded at a significant discount since COVID first hit over three years ago. As with any investment, MDIF unit holders can benefit from exposure to MXT in a situation where the unit price returns to NAV but MDIF's returns would be negatively impacted by an MXT capital depreciation. This risk is unique to MDIF unlike other unlisted credit offerings and while we do not expect such a scenario, this should be a consideration of investors.

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

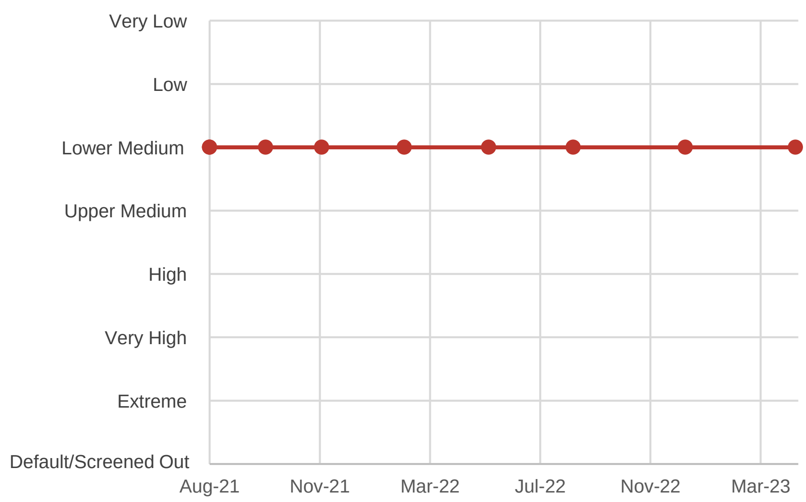
Once again off the back of rising swap rates, the expected outcomes both at a distressed and neutral simulation level have improved versus the previous experience (as at 31 December 2022). Our modelling continues to screen the portfolio as demonstrating impressive downside protection in distressed scenarios along with robust risk-adjusted returns. The high level of returns predictability is especially pertinent in the GFC-like scenario. The lack of deviation in modelled outcomes is driven by the high level of diversification in the portfolio.

In credit portfolios, the largest downside risk is counterparty concentration and conversely, the largest capital protector is diversification. Next in terms of capital protection is seniority. Over the last 18 months there have been targeted improvements at both levels. The number of individual borrowing counterparties in the portfolio has risen from 208 to 306 and the portion of senior secured exposures ex cash has risen from 87% to 91%. Both of these features drive lower losses given default, and subsequently better expected performance in the downside scenario.

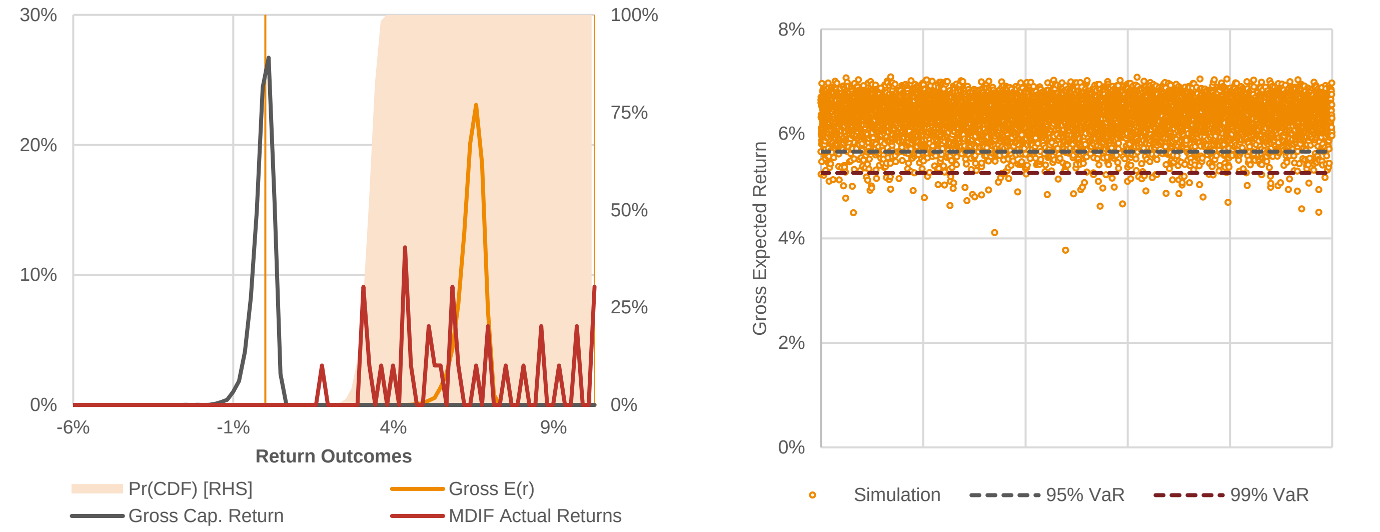
On the other hand, the Fund's cash holdings from Sep-21 of 10.0% have been reduced to 0.1% at Mar-23 and with nearly all of these funds deployed into sub-investment grade loans. Over this 18-month period, the exposure to sub-IG has increased from 42.2% to 51.0% while IG holdings excluding cash are relatively unchanged. Although this is credit negative, diversification and seniority benefits have more than offset this detraction.

Since the start 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 (97.9%) of floating-rate holdings. This has driven noticeably stronger performance under the baseline scenario while the benefits of diversification have added to the rising rate tailwind in the GFC-like environment. The 99% VaR for the baseline and distressed environments has improved to 5.25% and 1.76%, respectively. This is substantially improved on 12 months' prior at 2.64% and 0.87%. Our risk score is reiterated as being "**Lower Medium**" or "A", a credit rating band above the weighted average credit profile, which is a function of the supreme level of counterparty diversification.

Figure 12. Risk Score

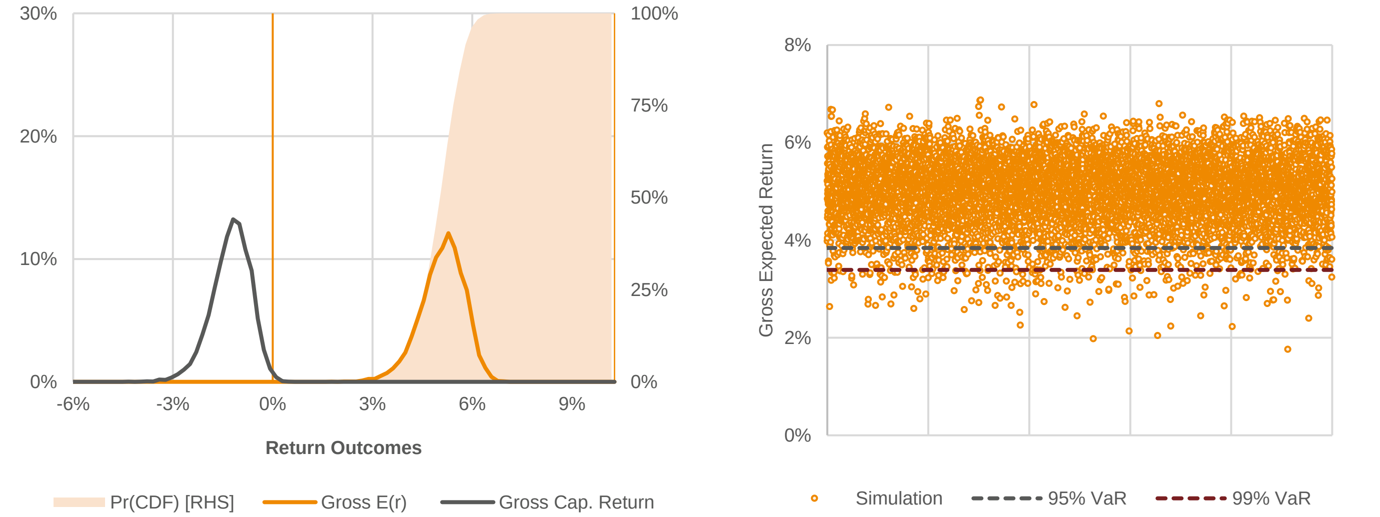


Scenario 1. Baseline Asset Assessment



Source: BondAdviser Estimates as of 31 March 2023 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 31 March 2023 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 – 7 July 2023

MDIF Update Report – 7 December 2022

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 23 October 2023.