Fund Research

Metrics Income Opportunities Trust (ASX: MOT)

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Overview

The Metrics Income Opportunities Trust (ASX: MOT) is a listed investment trust (LIT) that enables investors to easily gain exposure to the Australian private credit market, via an actively managed portfolio of primarily floating rate private credit investments.

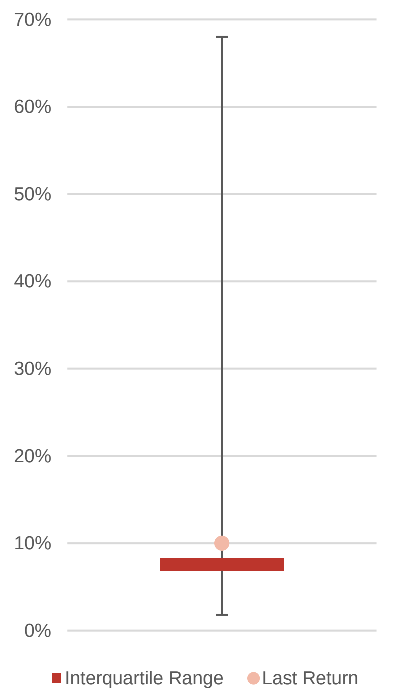
Private credit is a broad asset class that includes investments across the entire capital spectrum, from senior secured loans through to equity-like investments. Accessing this market has not been easy for retail investors as historically it has been limited to institutional investors and major global banks.

The underlying investment portfolio is managed by Metrics Credit Partners Pty Ltd (MCP, Metrics), an experienced alternative asset manager with specialist expertise and a strong track record in the private credit space. The Trust has invested in the Metrics Wholesale Income Opportunities Trust (WIOT), which, in turn, invests in wholesale funds that participate across the credit risk spectrum and are managed by Metrics.

The investment objective of the Trust is to provide attractive risk-adjusted returns with a **target return of 8 – 10% p.a. net of fees**, over a three-year period, with cash distributions payable monthly at a target of 7% p.a.

As at 31 March 2023, the market capitalisation of MOT was $531 million, with net asset value (NAV) at $565 million.

Figure 1. Monthly Net Returns Box Plot



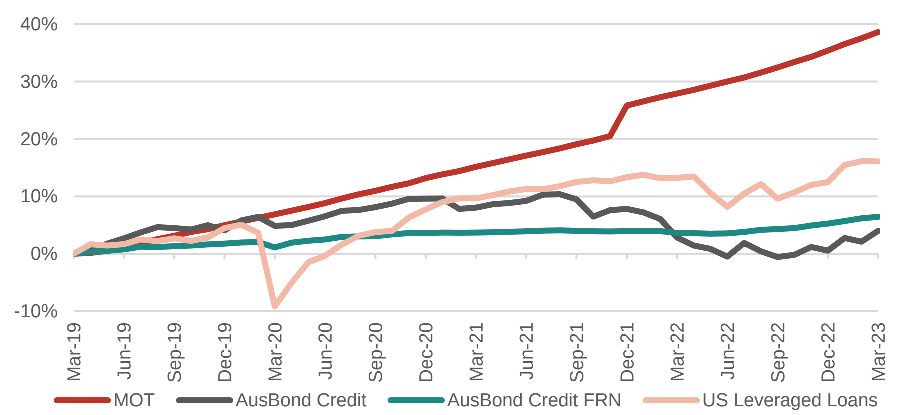
Source: BondAdviser, Metrics. Average annualised monthly returns, after fees since inception.

Figure 2. Monthly Net Returns* (%)

	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	YTD
2023	0.86	0.72	0.80										**2.38**
2022	0.58	0.57	0.52	0.50	0.56	0.55	0.55	0.65	0.69	0.71	0.67	0.80	**7.35**
2021	0.60	0.48	0.67	0.56	0.57	0.56	0.53	0.53	0.61	0.55	0.65	4.42	**10.72**
2020	0.61	0.60	0.59	0.60	0.60	0.62	0.73	0.67	0.55	0.63	0.56	0.78	**7.54**
2019				0.15	0.36	0.58	0.74	0.68	0.56	0.65	0.47	0.66	**4.86**

Source: BondAdviser, Metrics. As at 31 March 2023.
** 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 12 for unit price variance.

Product Assessment

Recommended | Improving

MOT continues to exceed its returns target over a 24-month rolling period, and we anticipate a period of substantial outperformance in the near future, largely driven by the fixed-rate nature of the target.

MOT is invested in four unlisted wholesale funds managed by Metrics: the MCP Secured Private Debt Fund (SPDF), MCP Secured Private Debt Fund II (SPDF II), the MCP Real Estate Debt Fund (REDF), and the MCP Credit Trust (MCP CT). As a result, these foundational funds offer MOT investors a diversified portfolio that includes corporate loans, notes, and bonds, as well as the possibility of benefiting from equity-like opportunities such as preference shares and warrants.

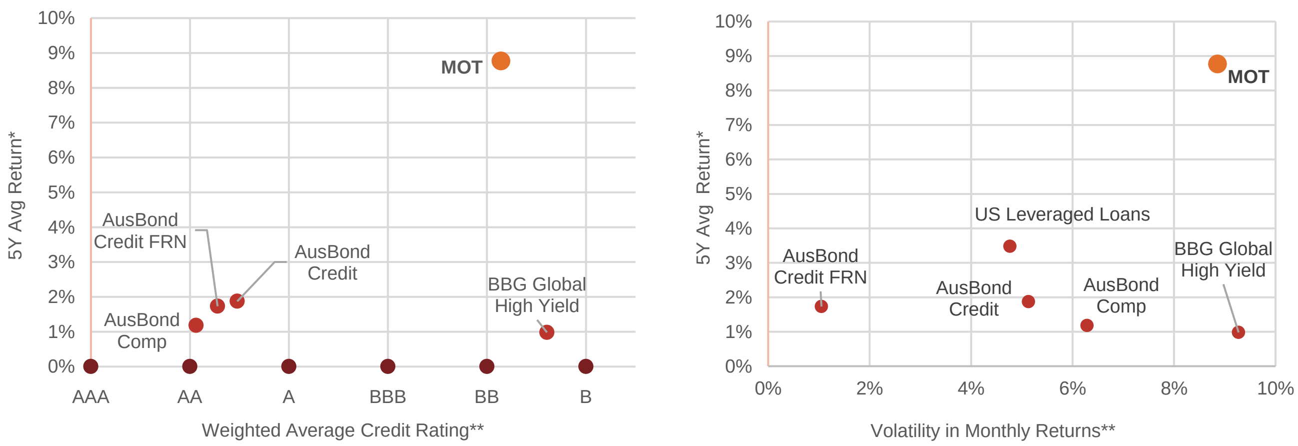
The Fund also offers diversification advantages to investor portfolios due to its reduced correlation with conventional asset classes. Additionally, it presents the potential for appealing risk-adjusted returns, supported by Metrics' proven track record in private credit, robust governance, and established processes.

MOT continues to outperform its returns target and has done so as at 31 March 2023 on a rolling 12-month, 24-month and since inception basis with net returns of 8.36%, 9.72% and 8.64% per annum, respectively.

In a scenario of higher interest rates, the investment portfolio, which is heavily concentrated in the real estate sector, faces escalating risks of default. On a positive note, around 75% of the real estate loans are senior secured and 59% mature within a year, alleviating some of this concern.

The risk profile of the underlying portfolio has largely deteriorated over the Mar-23 quarter as a function of increased non-senior ranking exposures, lower average credit ratings, a reduction in counterparty diversification and a rising portion of the portfolio rolling off in the near term. MOT has a fixed return target of 8-10% over a 3-year period, however Metrics earns a performance fee of 15.38% p.a. for total returns above the Trust Hurdle which is the RBA Cash Rate plus 6.00%. With the RBA Cash Rate having risen by 4% and 77% of the portfolio being floating rate, nearly half of the target return is now being achieved by the risk-free rate. We do not expect there to be an intentional reduction in risk exposures now that the target is more easily achievable in the near term. This is an opportunistic strategy, and the target is for 8-10% through the cycle. As such, in the short term we view it likely that MOT exceeds its target return. A lack of conservatism is confirmed by the Fund's metrics to do with credit rating, seniority, and concentration all pointing towards an incrementally riskier portfolio than in recent times. This indicates the Fund is still targeting the best risk adjusted returns despite the now easier to meet target return.

Figure 4. Estimated Risk-Adjusted Return Comparison



** All returns for indices calculated using annualised monthly returns for the past five years. Average return for MOT calculated since inception in April 2019.*
*** Credit Ratings based on BondAdviser estimates. *** Calculated based on annualised monthly returns data for past five years for indices and since inception for MOT. Source: BondAdviser, Metrics, Bloomberg. As at 31 March 2023.*

While the Fund is relatively risky in nature, there are still risk exposure elements of the Fund that need addressing. The first of these is the underlying portfolio has an 82% exposure to real estate on a committed loan basis excluding cash. Positively, and somewhat offsetting this, is that the large majority (75%) of this real estate exposure is senior secured and 59% of total real estate exposures mature in less than 12 months. A secondary point of concern is the general ability of the Fund's portfolio companies to meet the higher interest payments following base rates rising by 4% amidst a contracting economy. It is worth noting that Metrics have never had a default let alone any borrowers being in arrears greater than 30 days. This reflects Metrics' thorough screening processes designed to instill confidence in complete repayment before investing funds.

MOT currently meets all criteria bar one to be upgraded to Highly Recommended, being that BondAdviser has not yet been able to conduct research on the Fund for five years. This is a function of MOT have been incepted four years ago. As there is less than a year until this criteria is met and there is no expectation for MOT to fall behind on any other of the criteria, we move our outlook on the Fund to **Improving** and reiterate a **Recommended** product assessment.

Construction and Investment Process

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

Portfolio Risk Management

A number of crucial inputs to portfolio risk have seen minor deterioration over the Mar-23 quarter, with the combination of these weaknesses culminating in weaker results in our *Quantitative Analysis*. The most important function of a credit portfolio is its capital protection due to the negative skew in expected return distributions along with the returns ceiling on most securities. As such, the most important pillar in a credit portfolio's risk management is the level of diversification because the more concentrated a portfolio, the more impactful a default will be on fund's returns. Although this report is completed at a point in time each quarter and things will change over the course of the period, the recent downtrend in diversification coupled with the worsening loan maturity profile is cause for attention but not concern.

Unique borrower exposure remains high but has fallen from Dec-22 levels of 178 to 169 while the number of individual investments has fallen over the same period from 270 to 259. Additional to the counterparty consolidation is the pressure on the investment team to originate new loans over the next 12 months with 51.3% of the portfolio maturing in less than a year. This roll-off is 10.6 percentage points higher than a quarter ago and is higher than the 28.4% as at 31 December 2021. This heightened roll-off increases the potential for cash drag should the Manager struggle to fully redeploy the funds as they come available.

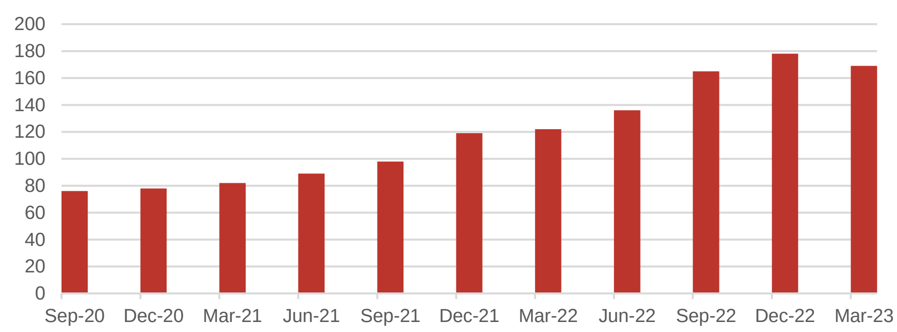
That said, management have put these concerns at ease in confirming the recent retraction of banks from the corporate loan space has resulted in an influx in opportunities for Metrics to assess for capital redeployment. Not only is there a greater number of deals available to the manager, but the majority of these new offers are for higher quality borrowers that were previously customers of the banks that are now competing for Metrics to lend to. The increased pipeline is reassuring and offsets issues surrounding roll-off and increasing concentration risk. 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.

Portfolio credit quality has also worsened over recent periods as the portion of sub-investment grade securities in the Fund has decreased from 70.1% at Mar-22 to 63.0% at Mar-23. The majority of this shift has come at the "B" rating where the Fund's exposure has risen from 7.3% a year earlier to 17.3% now. Additionally, over the past four quarters there has been a consistent and gradual shift away from senior secured to both subordinated and equity positions. At 30-Jun-22, the exposure to senior secured was 77.7% compared to 68.4% at 31-Mar-23. This shift has seen a 6.6 percentage point increase to equity and a 3.7ppt higher weighting to subordinated positions.

It is worth noting that the reason for these ostensibly worsening credit metrics could be a function of the Manager being presented with better risk-adjusted opportunities at a lower point in the capital stack and/or the credit rating ladder. At this current point in the cycle, it is logical for banks to shy away from riskier deals in a bid to reduce exposure to any potential losses. Such a move would create a larger opportunity set for MOT at the riskier end of the spectrum as borrowers' funding options shrink, allowing for Metrics to price deals more attractively. As cash levels remain low at 0.1% despite the steep maturity cliff, we expect this to be true.

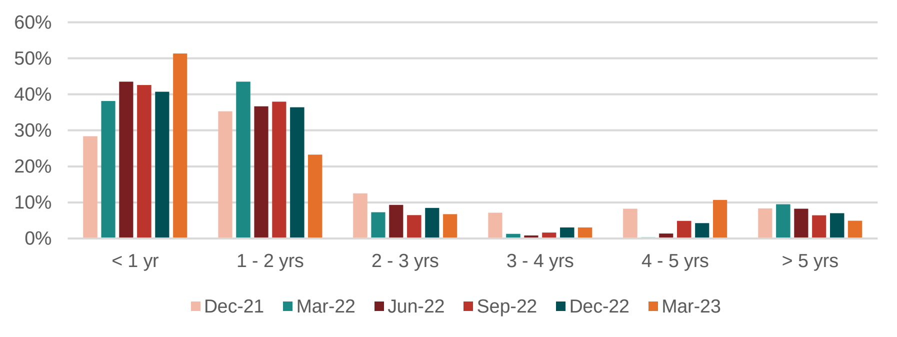
It would not be unfair to view this as the beginning of such a trend, meaning the MOT portfolio could continue to tilt towards riskier investments as it captures these opportunities. It is worth noting that Metrics may vary the portfolio construction in its absolute discretion and there are no restrictions in the MOT PDS as to asset allocation amongst the four wholesale funds that the Trust can allocate to. MOT should be seen as an alternative investment that is return-seeking. As such, superficially negative trends in portfolio credit metrics are not of concern as the manager is allocating to what it identifies to be the best risk-adjusted investment opportunities.

Figure 5. Unique Borrower Exposure Over Time



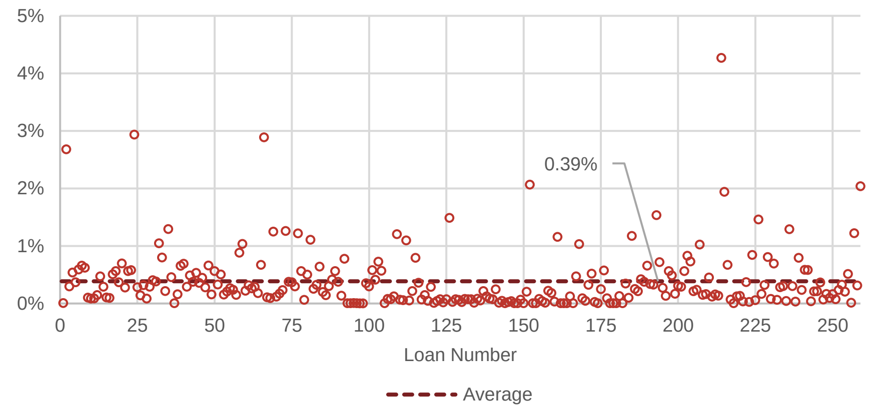
Source: BondAdviser, Metrics. As at 31 March 2023. Based on Metrics' underlying portfolio (WIOT) not MOT.

Figure 6. Portfolio Maturity Over Time



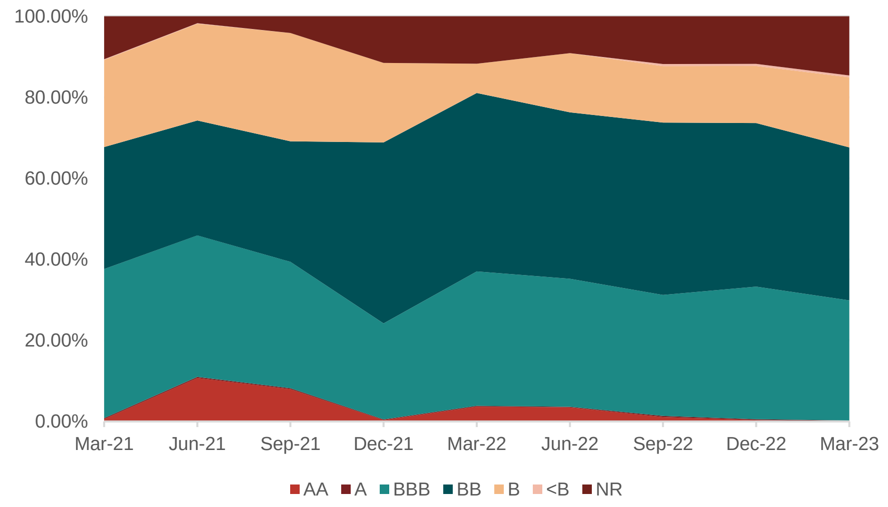
Source: BondAdviser, Metrics. As at 31 March 2023. Based on Metrics' underlying portfolio (WIOT) not MOT.

Figure 7. Portfolio Individual Loan Mix*



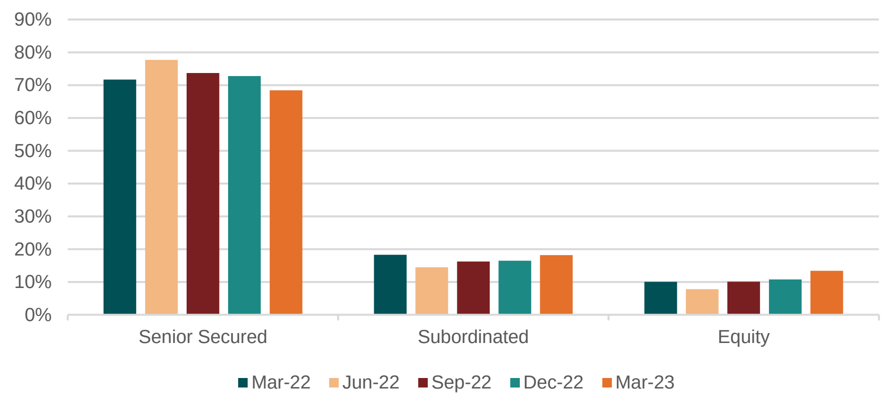
*Source: BondAdviser, Metrics. As at 31 March 2023. *Excluding cash. Based on Metrics' underlying portfolio (WIOT) not MOT.*

Figure 8. Portfolio Credit Rating Mix*



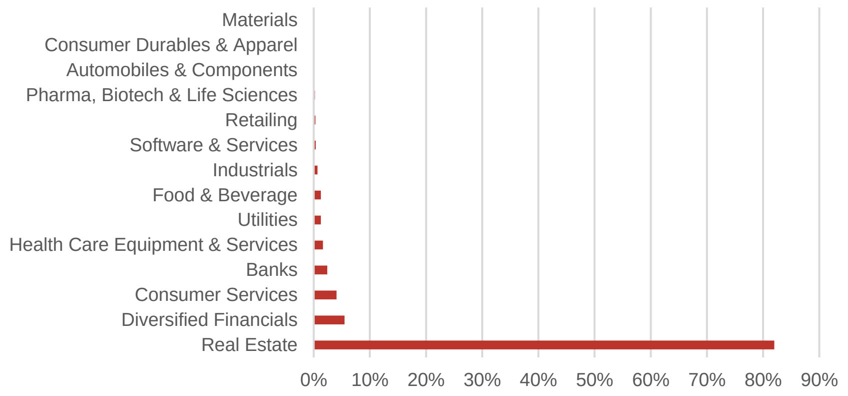
*Source: BondAdviser, Metrics. As at 31 March 2023. *Excluding cash. Based on Metrics' underlying portfolio (WIOT) not MOT.*

Figure 9. Portfolio Seniority Mix*



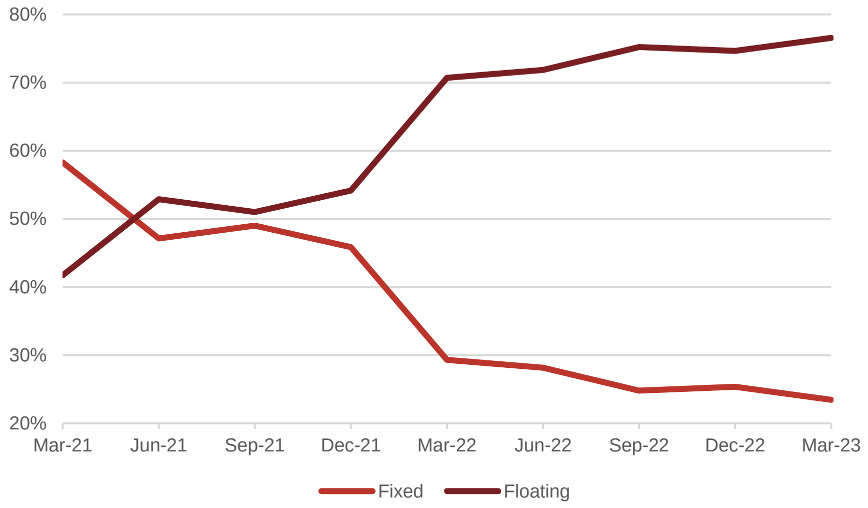
*Source: BondAdviser, Metrics. As at 31 March 2023. *Excluding cash. Based on Metrics' underlying portfolio (WIOT) not MOT.*

Figure 10. Portfolio Mix by S&P Industry Group*



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

Figure 11. Portfolio Mix by Rate Type*

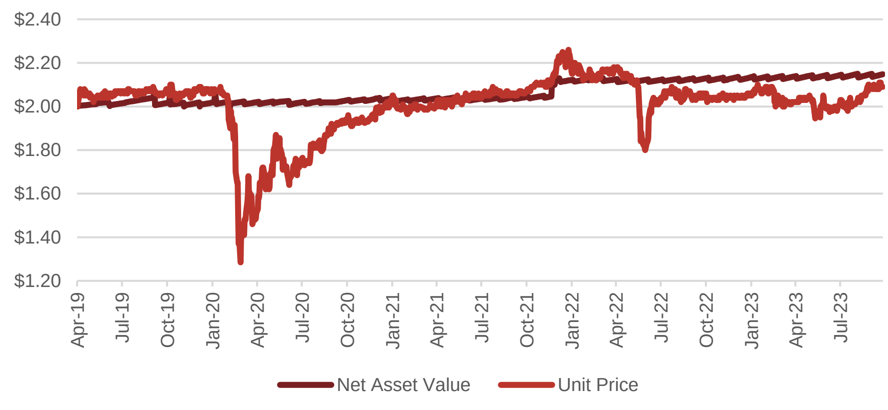


*Source: BondAdviser, Metrics. As at 31 March 2023. *Excluding cash. Based on Metrics' underlying portfolio (WIOT) not MOT.*

Fund Governance

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

Figure 12. Net Asset Value Against Unit Price



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

The structure of the Trust has not changed and is outlined in prior reports (see page 4 of MOT Update Report – 21 April 2021).

Disrupted markets in June 2022 led to a discount as high as 15.2% between the MOT unit price and NAV, which is understandable considering the market turmoil, but in our opinion was largely irrational. We view such bifurcation as illogical when contextualised against daily NAV updates and monthly performance updates from Metrics. Although the Fund's underlying investments are not traded and therefore not revalued as frequently as publicly traded credit, Metrics conducts weekly portfolio stress testing and has independent monthly portfolio valuation and impairment testing undertaken by an accounting firm. These processes provide us with some comfort around stated NAV, however a lack of tangible supportive mechanisms such as unit buybacks are a shortfall for MOT.

Following the COVID-related global financial markets wipeout, Metrics incepted the Metrics Direct Income Fund which is unlisted and invests in the same underlying portfolio as the Metrics Master Income Trust (ASX: MXT), but also has the ability to invest in units of MXT. This fund benefits the MXT unit price as in moments of NAV discount, MDIF can purchase MXT shares, supporting the unit price. While the size of MOT (NAV of $565 million at 31-Mar-23) is considerably less than MXT and MDIF (NAVs of $1.76 billion and $958 million at 31-Mar-23), as the NAV disconnect has been outstanding for 15 months now, there is merit to an unlisted fund that has the ability to invest in units of MOT as well as the WIOT. Alternatively we would welcome MOT unit buybacks or any other tactic to support the MOT unit price, however following MXT having recently traded back above NAV since 29 August 2023, there has been positive price movements for MOT also. This suggests there is a relationship between MXT and MOT, or broader LITs more generally, which would counter the argument for an unlisted strategy that can invest in both the WIOT and MOT. The discount was 2.7% as at 20 October 2023 and has averaged -2.8% for the past 30 trading days.

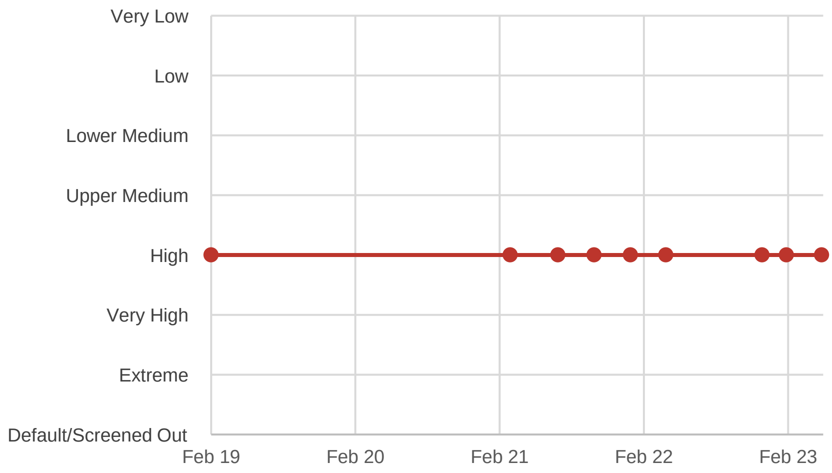
Quantitative Analysis

Once again off the back of rising swap rates, the median expected returns in our neutral simulation have improved to 7.56% versus the previous experience of 7.35% (as at 31 December 2022), however there has been deterioration in the credit quality of the portfolio since last quarter. As such, the lift from swap rates has not been enough to offset the impacts of a weaker portfolio at the tail end of our baseline scenario and especially in the distressed environment. The previously robust downside protection of -3.13% gross return 99% VaR in our GFC modelling has deteriorated considerably to -5.09% this quarter. The modelled outcomes in the distressed scenario have become increasingly negatively skewed and the standard deviation of expected returns has also risen. All of these are a result of deteriorating portfolio attributes with the most impactful of which being a shift in weighting to lower credit ratings and an increase in exposure to subordinated and equity-like investments.

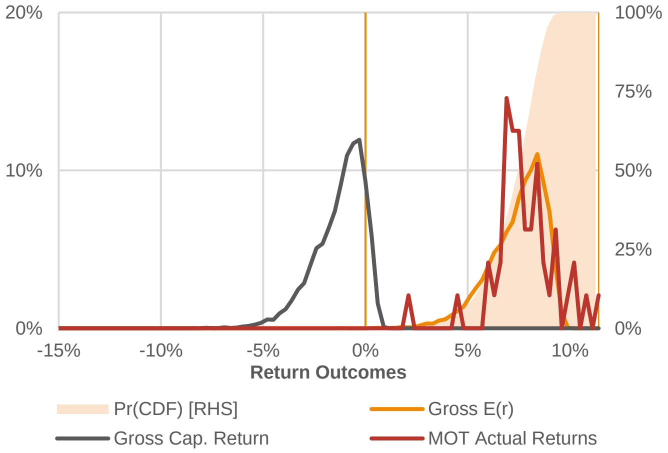
Investments with lower credit ratings are more likely to default than those of higher credit rating, especially in the 2009 scenario. Additionally, the more subordinated the investment is on the capital stack, the greater the loss in an event of default. As such, the recent portfolio positioning into riskier credits further down the capital stack has proven detrimental to the modelled outcomes for MOT. An additional factor detracting from capital protection has been a slight uptick in concentration versus Dec-22. The number of individual investment exposures in the Fund has decreased from 270 three months ago to 259. In credit portfolios, the largest downside risk is counterparty concentration, however despite the slight reduction, the level of diversity in MOT remains high.

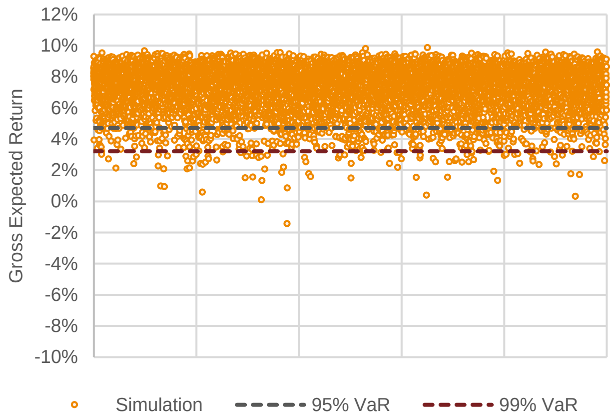
While quarter-on-quarter, the portfolio's quality has retraced, our modelling has substantially improved over the past two and a half years due primarily to diversification benefits. In September 2020, the portfolio consisted of 76 individual borrowers to 169 as at Mar-23 (peak of 178 at Dec-22). Our Risk Score remains "**High**" or "BB", in line with the portfolio's weighted average credit rating. Improvements in diversification could see the Risk Score notched upwards.

Figure 13. Risk Score



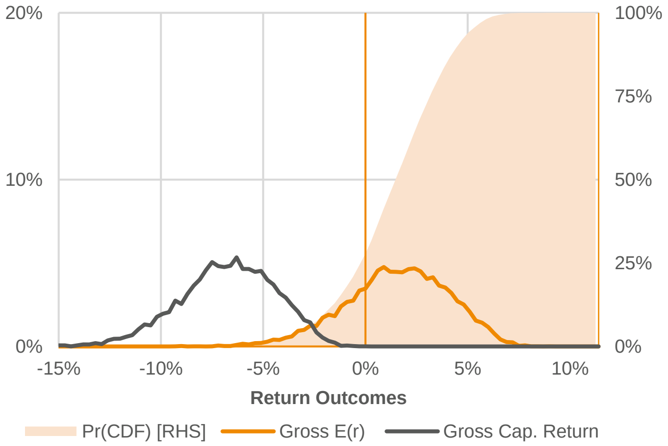
Scenario 1. Baseline Asset Assessment

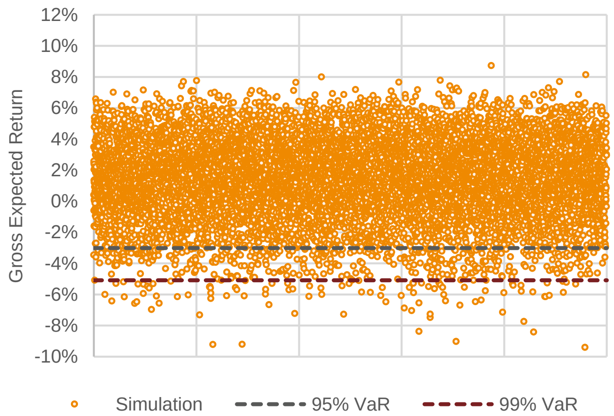




Source: BondAdviser Estimates as of 31 March 2023 portfolio. Excludes impact of management and origination fees. Gross capital returns excludes the value of coupons/income and is only modelling impairment or loss given default, based on historical credit data from Moody's. Impact of traded price is not 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

MOT Update Report – 22 December 2022

MOT Update Report – 22 October 2022

MOT Update Report – 26 May 2022

MOT Update Report – 27 April 2022

MOT Update Report – 5 November 2021

MOT Update Report – 21 August 2021

MOT Update Report – 29 April 2021

MOT IPO Report - 28 February 2019

Alternative Investment Fund Research Methodology

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Report created on 23 October 2023.