Fund Research

Metrics Direct Income Fund

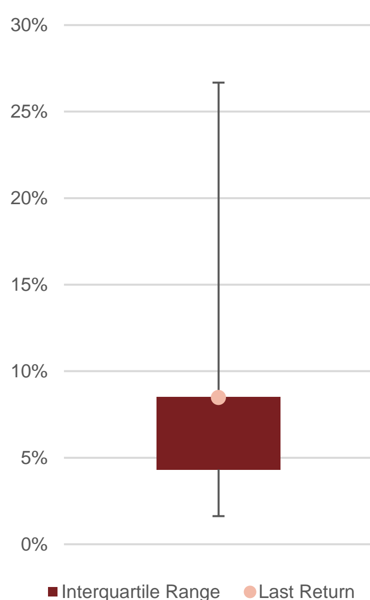
Overview

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



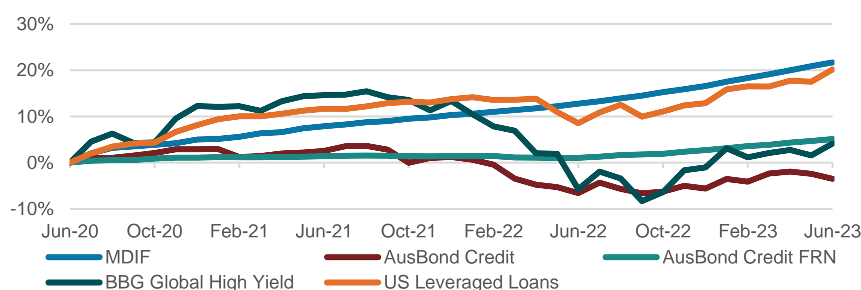
Source: BondAdviser, Metrics. Annualised monthly returns, after fees since inception. As at 30 June 2023.

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	0.71	0.75	0.68							**4.32**
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 30 June 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 30 June 2023. Calculated from cumulative net monthly returns of the Underlying Fund. Returns on NAV, not traded unit price.

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 offers retail investors the opportunity to access the domestic commercial lending market. The Fund mainly consists of senior secured, floating rate loans to both investment-grade and sub-investment-grade companies. This is an unlisted and open-ended Fund, and it gains its exposure primarily by investing in the MCP Wholesale Investment Trust (WIT), with the option to invest in Metrics Master Income Trust (ASX: MXT), which exclusively invests in the WIT.

The WIT is composed of three wholesale Funds managed by Metrics: 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). These funds are allocated in a split of roughly 60/20/20, and the allocation is at the discretion of Metrics, between 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 by quite a margin. On a rolling 24-month basis to 30 June 2023, MDIF returned 6.22% p.a. (net assuming reinvestment of distributions) and generated a net annualised return of 6.77% since inception in July 2020. The benchmark of RBA Cash Rate + 3.25% has returned 4.80% p.a. and 4.31% 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 (2.9% premium to NAV at 2 January 2024 close).

While the majority of the portfolio consists of floating-rate assets, which are directly shielded from the impact of higher interest rates, we must consider the indirect potential risks for the portfolio associated with rising rates and the prevailing inflationary environment in terms of the borrower's creditworthiness. Given the current stage of the credit cycle, particular caution is warranted regarding the roughly 55% exposure to real estate in the underlying portfolio, with approximately 20% of this exposure tied to real estate development. It is worth noting, however, that the majority of the real estate loans hold the highest priority in the capital structure as senior secured, providing a strong layer of protection since any initial losses are first absorbed by subordinated or equity tranches in the borrower's capital structure. Additionally, it is essential to recognise Metrics' commendable track record in initiating, structuring, and overseeing investments in commercial real estate credit. Equally important when balancing the real estate exposure is the fact that the Manager does not extend loans to construction contractors.

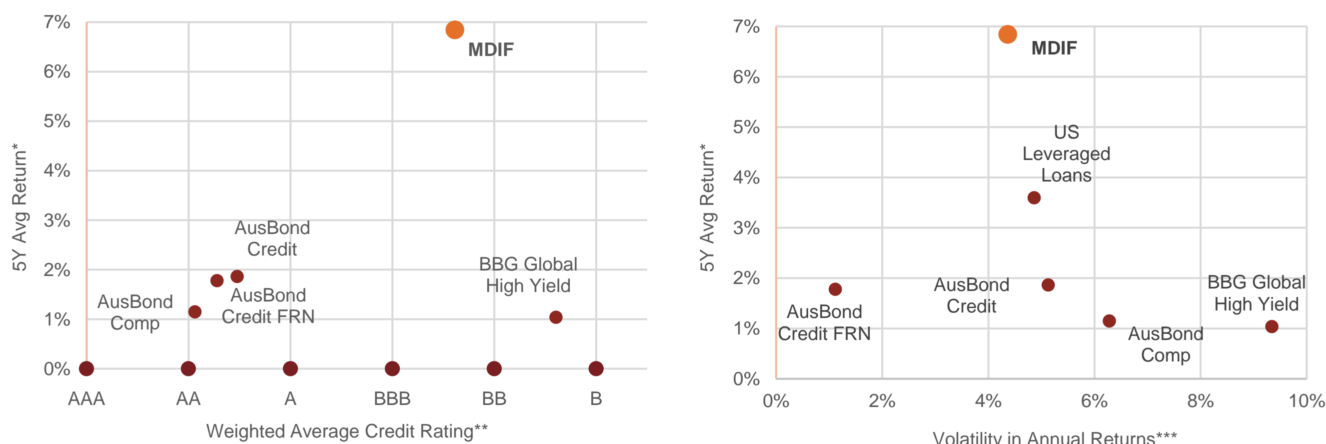
In response to the deteriorating economic conditions, banks are implementing stricter lending policies. This shift has expanded the spectrum of investment possibilities for Metrics, as borrowers who previously qualified for bank financing are now compelled to explore alternative sources of capital. As a result, there is a more significant pipeline of opportunities than would typically be anticipated at this stage of the economic cycle, and it has shifted the balance of pricing power in favour of the Manager. This dynamic enables the replacement of maturing loans in the underlying portfolio with only the most attractive opportunities in terms of risk-adjusted returns.

An impressive aspect of Metrics' track record is the absence of any defaults resulting in no impact on investor returns. Given the diverse and extensive range of counterparties to which Metrics extends loans, we attribute this achievement to their stringent screening protocols designed to establish trust before the precise allocation of funds.

Overall, we maintain a strong belief in Metrics' capacity to sustain effective systems and protocols for originating and structuring loans, as well as their diligent supervision of performance to mitigate credit risk, both at the individual loan and portfolio levels. Portfolio-level risk is mitigated by the diversification provided by 300 distinct counterparties. Meanwhile, at the individual loan level, 91% of the portfolio, as measured by commitments, consists of senior secured positions. These elements collectively serve to lower the potential loss to the portfolio in the event of a counterparty default.

On its own, MDIF would meet the criteria for a Recommended product assessment based on its inherent qualities. However, it receives an unusual upward adjustment for the following reasons: (1) BondAdviser's independent evaluation of the underlying funds; (2) these funds have consistently exceeded their target returns in the past two years; and (3) MDIF does not necessitate FX hedging into the WIT or MXT. Consequently, since MXT holds a Highly Recommended rating, MDIF qualifies for an equivalent evaluation. Therefore, we maintain our atypical top-tier product rating 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 30 June 2023.

Construction and Investment Process

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

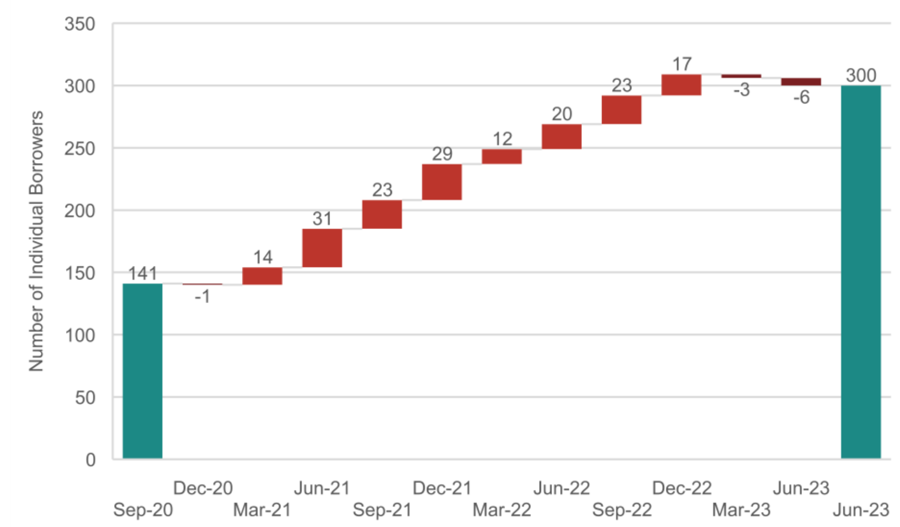
Portfolio Risk Management

At its most fundamental level, a private credit portfolio’s risk level is determined by the expected losses which are driven by defaults and recovery rates given defaults. We view there as being three primary drivers of this risk that can be managed by a credit portfolio manager: concentration, credit quality, and seniority. There are other factors that impact the portfolio from a risk perspective, but these three aspects are elemental to private credit funds such as this.

Diversification is important from a counterparty and individual loan exposure basis, but also when considering industry exposure and tenor buckets. The more diverse a

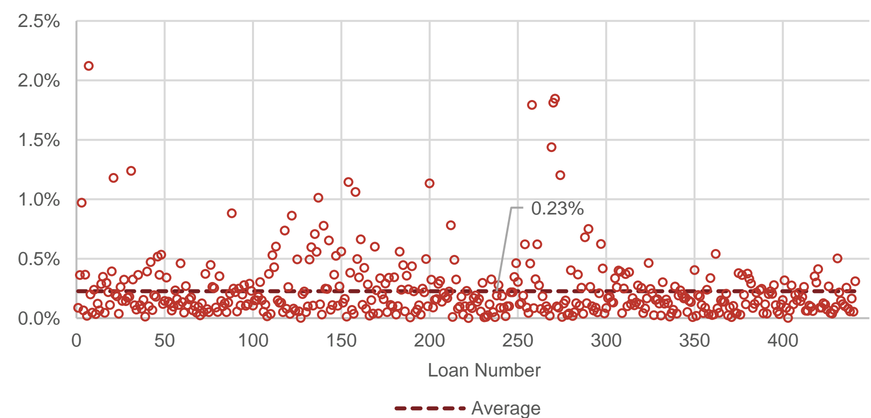
portfolio, the less the Fund would be impacted by a single counterparty defaulting. Two years ago, the portfolio had 296 investments across 185 individual borrowing counterparties. This has since grown to 441 loans and 300 borrowers while the average exposure has fallen from 0.34% to 0.23%, illustrating the general long-term diversification improvements. While positive on a long-term basis, there has been a slight reduction in diversification over the past six months with the portfolio having nine less counterparties than as at 31 December 2022.

Figure 5. Unique Borrower Exposure Over Time



Source: BondAdviser, Metrics. As at 30 June 2023. Based on Metrics' underlying portfolio (WIT) not MDIF.

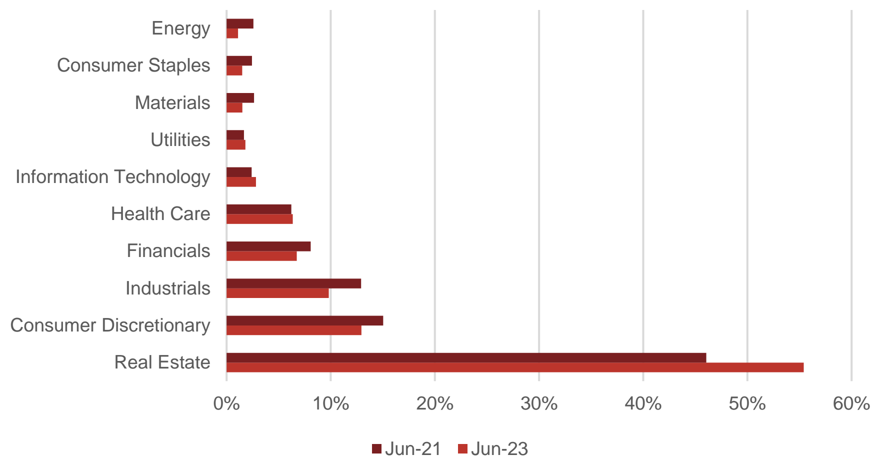
Figure 6. Individual Loan Exposure*



*Source: BondAdviser, Metrics. As at 30 June 2023. *Excluding cash. Based on Metrics' underlying portfolio (WIT) not MDIF.*

In terms of industry diversification, this is a weak point of the underlying portfolio as it has a 55.4% weighting to real estate, and its second largest exposure is 12.9% to consumer discretionary. We view both sectors as subject to economic headwinds in the near term and stress that investors gain comfort with Metrics' diligence and processes prior to investing in a Fund with greater than two-thirds of its FUM lent to borrowers operating in challenged sectors. Not only this but since 30 June 2021, the weighting to real estate has gradually increased to be now 9.4 percentage points higher than two years ago. We view this trend as credit negative and would prefer to see the Fund's weighting to real estate substantially reduced as asset cross-correlations are a vital aspect of credit portfolios.

Figure 7. Portfolio Exposure by S&P Sector*

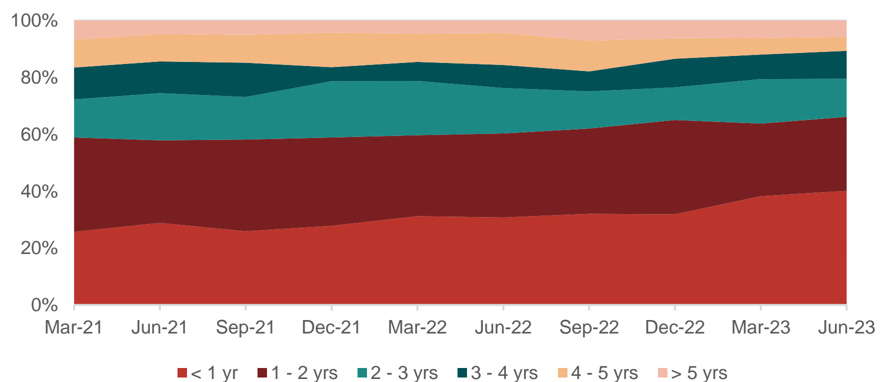


*Source: BondAdviser, Metrics. As at 30 June 2023. * Excluding cash. Based on Metrics' underlying portfolio (WIT) not MDIF.*

Over the six months from 31 December 2022 to 30 June 2023, the portfolio composition by tenor to maturity has risen from 31.9% maturing in less than a year to 40.2%. The increased roll-off creates additional pressure for the investment team's capacity to write fresh loans in a bid to avoid accumulating excess cash that could impede returns. The high rates backdrop makes the risk of cash drag particularly prominent, intensifying the urgency for efficient redeployment. That said, while having idle cash is undesirable, hastily investing in riskier credits at this stage of the economic cycle would be even more detrimental.

In Metrics's defence, the manager has consistently demonstrated its ability to efficiently recycle capital over several years, without adversely affecting the portfolio's credit quality or returns. Despite the larger-than-usual refinancing challenge ahead, we anticipate that Metrics will continue its successful track record in this regard, as there are ample corporate lending opportunities available at present.

Figure 8. Portfolio Loan Tenor Mix*

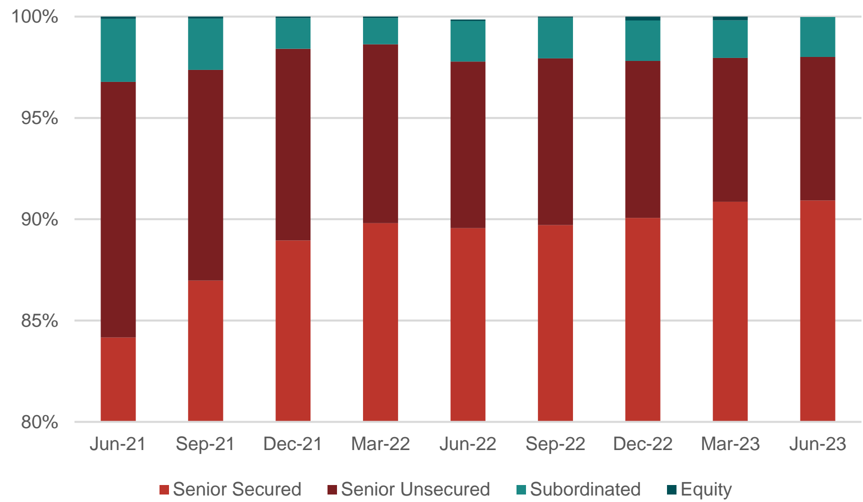


*Source: BondAdviser, Metrics. As at 30 June 2023. *Excluding cash. Based on Metrics' underlying portfolio (WIT) not MDIF.*

When looking at seniority, the long-term trend has been a positive one, with the portion of senior secured loans in the book growing from 84.2% at Jun-21 to 90.9% at Jun-23. The increased portion of first lien loans in the Fund provides investors with a higher expected recovery in an event of default, providing better capital protection. This

increased allocation to more senior tranches in combination with the aforementioned counterparty diversification is a substantial risk reduction to where the portfolio was two years' prior.

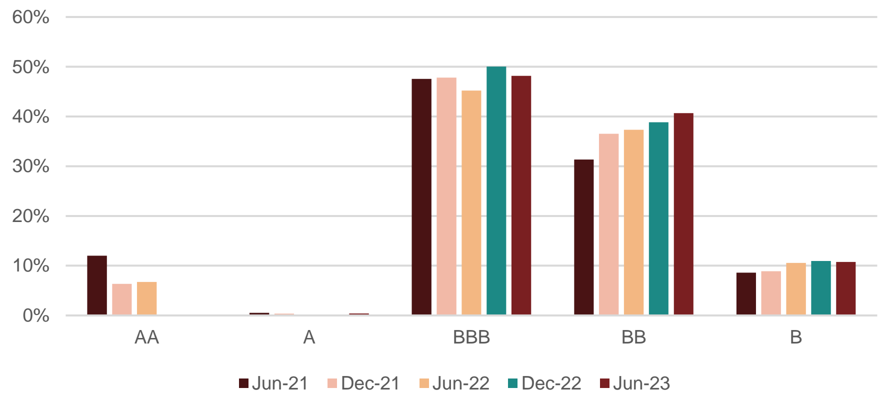
Figure 9. Portfolio Seniority Mix*



*Source: BondAdviser, Metrics. As at 30 June 2023. *Excluding cash. Based on Metrics' underlying portfolio (WIT) not MDIF.*

Again looking to June 2021 as a baseline, the portfolio had a 12.0% holding of cash (rated AA) at the time which has now been fully deployed with cash holdings of 0.1% at Jun-23. This 12% of the portfolio has almost entirely been allocated to BB-rated loans (+9.3%) with a slight uptick in B-rated loans (+2.2%) over the two-year period. This gradual tilt further into BB has interestingly tipped the weighted average credit rating of the portfolio from investment grade to sub-investment grade. We do not have an issue with this for a number of reasons. Firstly, this is a private credit fund, and the majority of investment grade borrowers would not engage private credit funds. Such a borrower would typically access bank loans or public credit markets as rates are more competitive than in private credit, resulting in a lower available pool of investment grade opportunities for Metrics to deploy into. Secondly, we have comfort in the Manager's processes and systems both at the origination stage and managing the counterparty during the life of the loan. Although this is a weakening in the portfolio's creditworthiness, it was to be expected as FUM grew, the number of investment grade opportunities that the WIT could deploy into would fall. If anything, we are pleasantly surprised by the Fund's ability to maintain a ~48% allocation to BBB loans as the size of the fund has increased from $1.7 billion drawn at Jun-21 to $3.9 billion drawn at Jun-23.

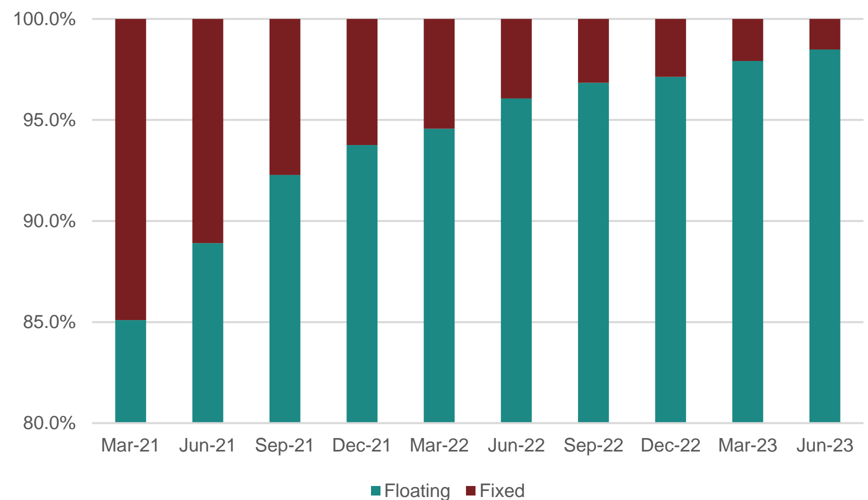
Figure 10. Portfolio Credit Rating Mix*



*Source: BondAdviser, Metrics. As at 30 June 2023. *Excluding cash. Based on Metrics' underlying portfolio (WIT) not MDIF.*

Also of note is interest rate risk (duration). While a portfolio of loans is typically immune to given the predominantly floating rate nature, the investor needs to be cognisant that in a rising rate environment, the borrowers have to meet higher interest payments and are therefore at higher risk of default as serviceability falls. This means that although there is not a direct price impact from interest rate rises, there could be one on the basis of weakening counterparty creditworthiness.

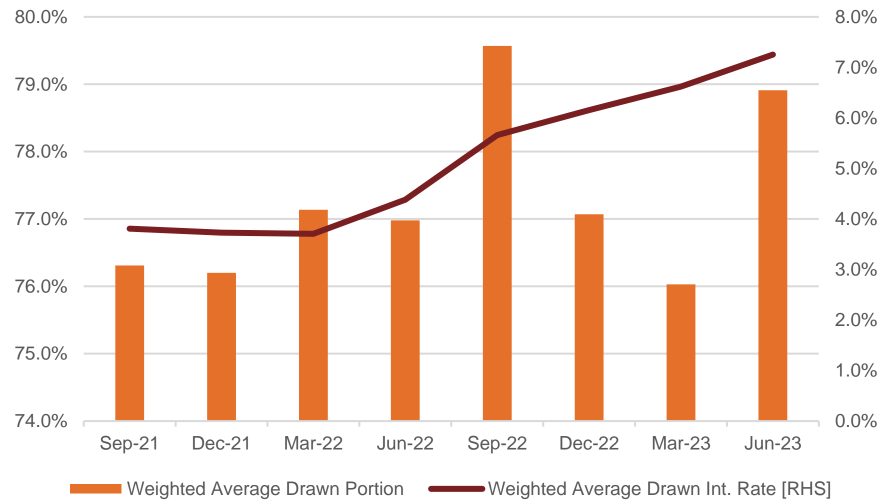
Figure 11. Portfolio Loan Interest Payment Mix*



*Source: BondAdviser, Metrics. As at 30 June 2023. *Excluding cash. Based on Metrics' underlying portfolio (WIT) not MDIF.*

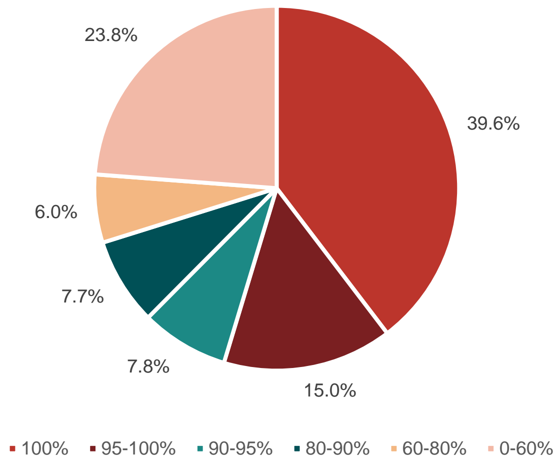
Typically when economic conditions worsen, businesses need more money to stay afloat, reinforcing Warren Buffett's saying that to a company, cash is like oxygen. Interestingly, the softening economic conditions are yet to have a material impact on Metrics' portfolio businesses as is evidenced by the substantial buffer of 21.1% in undrawn funds on a committed basis. Only 39.6% of loans on a committed basis are fully drawn as at 30 June 2023. It is worth noting that a significant portion of the undrawn loans are project/construction facilities. The average drawn rate for construction loans is 58.1% and these facilities comprise 26.3% of the underlying portfolio.

Figure 12. Portfolio Weighted Average Drawn Portion and Interest Rate*



*Source: BondAdviser, Metrics. As at 30 June 2023. *Excluding cash. Based on Metrics' underlying portfolio (WIT) not MDIF.*

Figure 13. Portfolio Weighted Average Drawn Portion and Interest Rate*

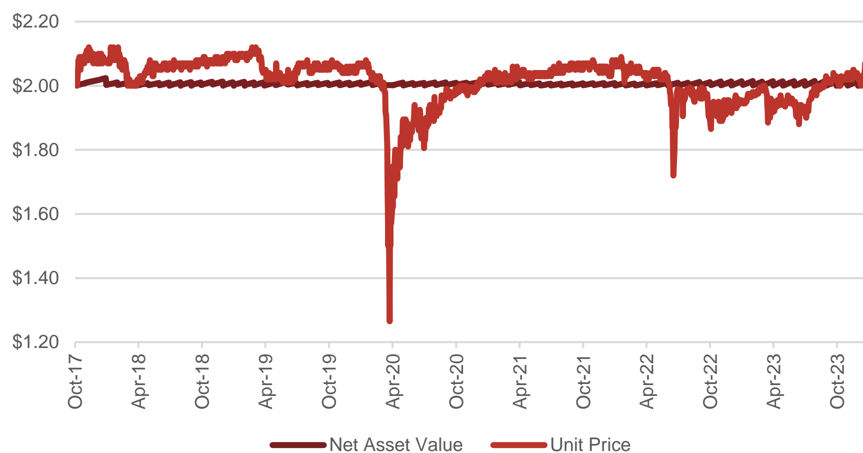


*Source: BondAdviser, Metrics. As at 30 June 2023. *Excluding cash. Based on Metrics' underlying portfolio (WIT) not MXT.*

Fund Governance

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

Figure 14. MXT Net Asset Value Against Unit Price



Source: BondAdviser, Metrics, Bloomberg. As at 2 January 2024.

MDIF has the ability to invest in the WIT or directly in units of Metric's ASX-listed fund, MXT. As at 30 June 2023, MDIF has allocated 6.7% 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 2.9% premium to NAV (2 January 2024 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

As the impact of rising rates has passed through the portfolio, across both the baseline and stressed scenarios, we have seen again seen improvements versus the previous experience (as at 31 March 2023). Our modelling highlights the portfolio’s remarkable ability to safeguard against losses in challenging situations, while also delivering strong returns relative to the level of risk. The significant predictability of returns is highlighted by the lack of drastic difference when contrasting the expected returns in a scenario akin to the Global Financial Crisis (GFC) versus a benign economic backdrop. The median capital return for the two scenarios are -0.96% and -0.11%, meanwhile the median capital return for MDIF’s underlying portfolio as at Jun 2021 in the same economic simulations were -2.34% and -0.32%, respectively. This is a manifestation of the continued high level of diversification and senior debt in the portfolio.

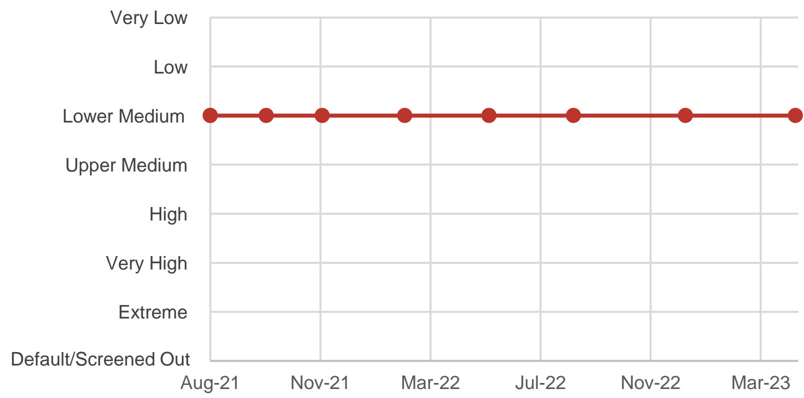
In credit portfolios, the most significant risk arises from an overconcentration of exposure to a single counterparty, with diversification playing a pivotal role in safeguarding capital. Seniority follows closely in importance for capital protection as lower-ranking capital takes losses first in an event of default (EOD). Over the last 12 months, MDIF has actively undertaken measures to enhance these aspects. This involved expanding the number of individual borrowing counterparties in the portfolio from 249 to 300 and persistently increasing the proportion of senior secured exposures. These strategic adjustments have resulted in decreased losses in an EOD and, consequently, have bolstered overall performance in adverse conditions (highlighted in the models below).

That said, MDIF has recently implemented slight alterations in its portfolio construction that have a negative impact on credit. As of June 30, 2023, the last 24 months have seen a notable rise in the quantity of sub-investment grade loans within MDIF's holdings. It is important to note that while this represents a credit-negative development, the advantages of diversification and seniority have effectively outweighed the adverse impact.

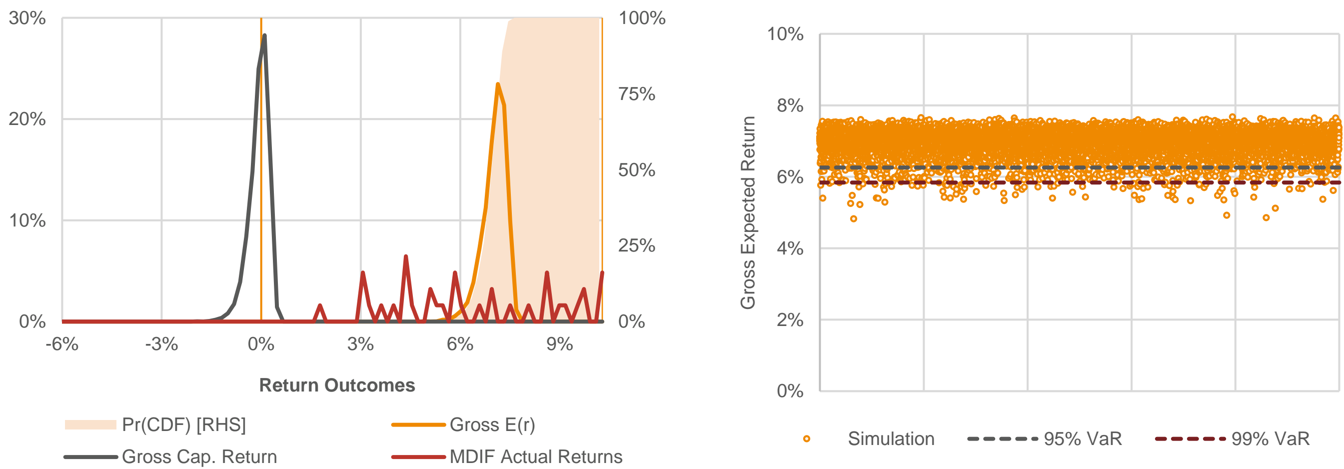
Additional to the strategic enhancements from increased diversification and seniority, MDIF has also increased the proportion of floating rate loans. This has been favourable in the rising rate environment as expected income has increased in tandem with the higher base rates, driving higher simulated gross returns.

The improved portfolio risk metrics underscore the positive impact of Metrics’ efforts and elucidate why our risk score remains consistently at **Lower Medium** or "A," a credit rating category a notch above the portfolio’s weighted average credit profile. This affirmation is attributed to MDIF's superior counterparty diversification, affirming its commitment to mitigating risk and enhancing overall portfolio resilience.

Figure 15. Risk Score

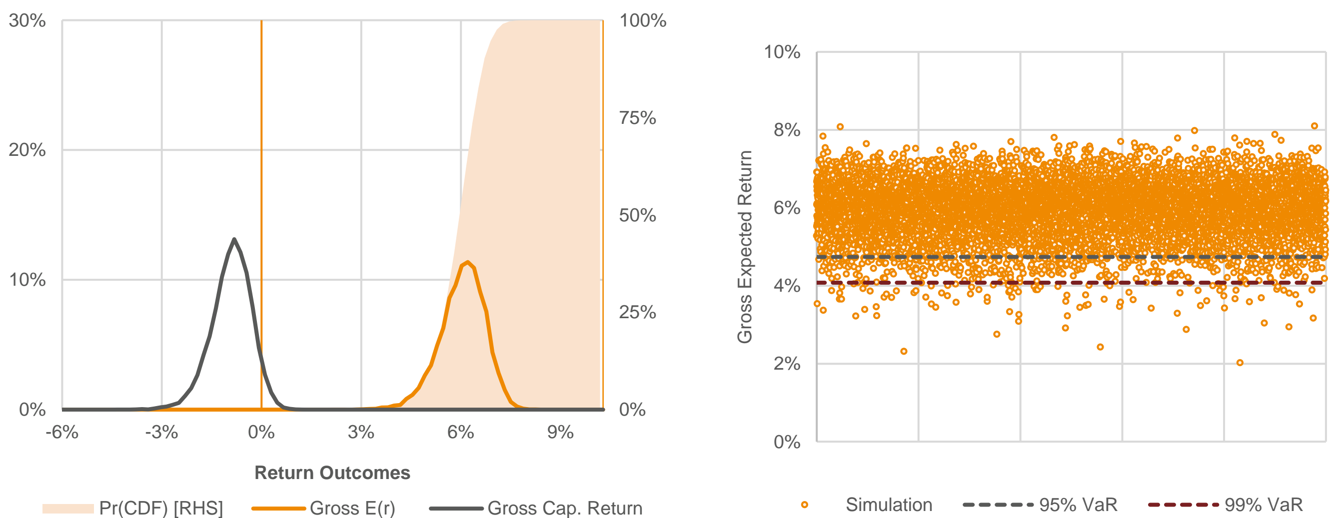


Scenario 1. Baseline Asset Assessment



Source: BondAdviser Estimates as of 30 June 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 30 June 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 – 23 October 2023

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

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