Fund Research

Metrics Direct Income Fund

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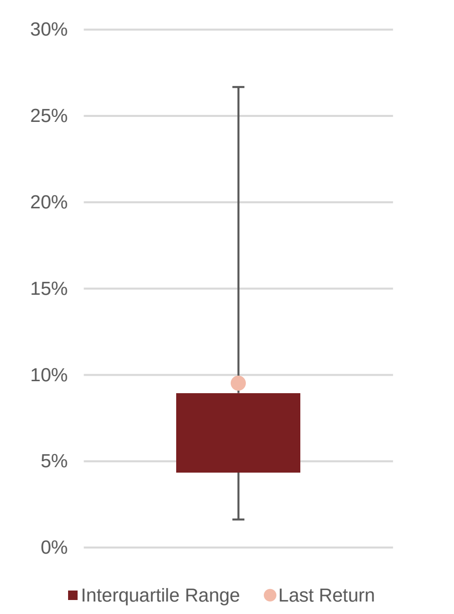
Overview

The Metrics Direct Income Fund ("MDIF", or the "Fund") is an unlisted open-ended unit trust which is domiciled in Australia. MDIF provides retail investors with access 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 also has a very similar fund to MDIF that is listed on the ASX, named the "Metrics Master Income Trust" (ASX: MXT), which listed on the ASX in October 2017. MDIF serves as an alternative investment vehicle for investor who wish for greater redemption certainty (with respect to NAV – as compared to the traded unit price of MXT), whilst providing exposure to the same underlying portfolio as MXT. Additionally, MDIF avoids explicit unit price risk unlike MXT. However, MDIF can hold MXT units which brings the unit price risk to the Fund at a minor level. It is crucial to emphasise that investors need to carefully consider this feature. While MDIF's strategic investment in discounted units of MXT can contribute to restoring the MXT unit price to NAV, its effectiveness might be limited in the context of widespread market selling, potentially offsetting the advantages of being an unlisted fund.

MDIF's objective is to provide stable capital value whilst achieving attractive income with a target return of the **RBA cash rate plus 3.25% p.a.** (currently 7.60% p.a.) **after fees**, payable monthly. The Fund Invests in the MCP Wholesale Investment Trust (WIT) which subsequently, invests in Metrics' wholesale institutional investor funds that are also managed by Metrics. Both MDIF and MXT invest in the WIT, however, MDIF can invest in units of MXT.

Figure 1. Monthly Net Returns Box Plot



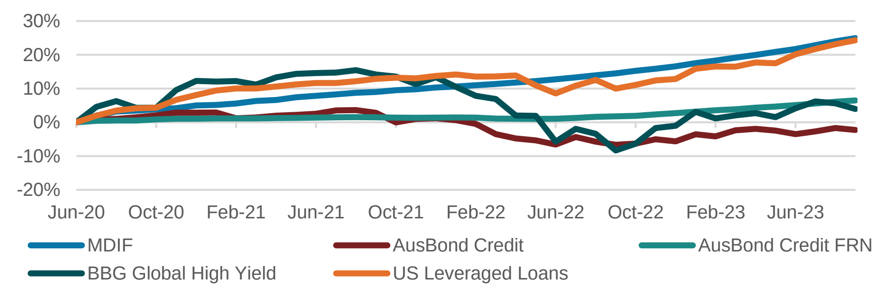
Source: BondAdviser, Metrics. Annualised monthly returns, after fees since inception. As at 30 September 2023.

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	0.95	0.93	0.76				**6.96**
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	**5.54**
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	**4.96**
2020							1.99	1.19	0.28	0.35	0.32	0.77	**4.90**

Source: BondAdviser, Metrics. As at 30 September 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 September 2023. Calculated from cumulative net monthly returns of the Underlying Fund. Returns on NAV, not traded unit price.

Product Assessment

Highly Recommended

MDIF is impressively outperforming its target returns by a fair margin consistently.

MDIF provides the opportunity of access to the domestic commercial lending market to retail investors. MDIF predominantly consists of senior secured, floating rate loans to both investment-grade and sub-investment-grade companies. The Fund is an unlisted and open-ended Fund which gains its exposure mainly by investing in the Metrics Credit Partners Wholesale Investment Trust (WIT), with the option to also invest in the Metrics Master Income Trust (ASX: MXT), which invests exclusively in the WIT. The WIT invests in three wholesale funds which are managed by Metrics. Approximately 60% is invested in the Metrics Credit Partners Diversified Australian Senior Loan Fund (DASLF), ~20% to the MCP Secured Private Debt Fund II (SPDF II), and ~20% to the MCP Real Estate Debt Fund (REDF).

The Fund is suited for those who seek low capital volatility, matched with an attractive monthly income from an actively managed portfolio of diversified domestic private credit. Additionally, the Fund also provides diversification benefits to investor portfolios given low correlations of private debt to traditional asset classes such as equity and fixed interest.

MXT's wholesale placement is beneficial for MDIF unitholders as the underlying strategy now has greater funds under management and the portfolio is likely to become more diversified.

MDIF is impressively outperforming its target returns by a fair margin consistently. On a rolling 24-month basis to 30 September 2023, MDIF returned 7.06% p.a (net assuming reinvestment of distributions) and generated a net annualised return of 7.09% since inception in July 2020. This is 168bps and 253bps respectively over the benchmark of RBA Cash Rate + 3.25%.

As it is an unlisted fund, MDIF should be relatively immune to unit price volatility. This is a feature that benefits the fund as listed funds can experience unit price volatility such as during periods of market distress. This was seen during the market sell-off in June 2022, which resulted in a dislocation between the unit price and NAV of listed funds. MXT also experienced this volatility which, subsequently, resulted in ~14 months of divergence and its unit price did not return to NAV until 28 August 2023. The listed Fund, MXT, continues to trade above NAV and a wholesale placement was completed on 1 December 2023, raising $196.4 million at $2.00 per unit. A Unit Purchase Plan was also announced on 29 November 2023, providing all MXT unit holders with the opportunity to subscribe for up to $30,000 worth of units at NAV. This offer which closed on 30 January 2024 raised a further $76.1 million. This is beneficial for MDIF investors as well, as MXT invests in the same strategy. The increased funds under management (FUM) for the entire strategy by around $272 million will likely lead to greater diversification benefits in the underlying portfolio.

While the predominant composition of the portfolio comprises floating rate investments, variations in interest rates can still impact its performance. An increase in rates may influence a borrowers' ability to fulfill repayment obligations, introducing higher risk due to a potential decline in their creditworthiness. We approach the significant allocation to real estate exposure, constituting around 52% of the underlying portfolio, with particular caution—this represents a 5.2 percentage point increase from two years ago. Notably, almost all real estate loans are senior secured, providing the highest level of protection against potential losses or defaults.

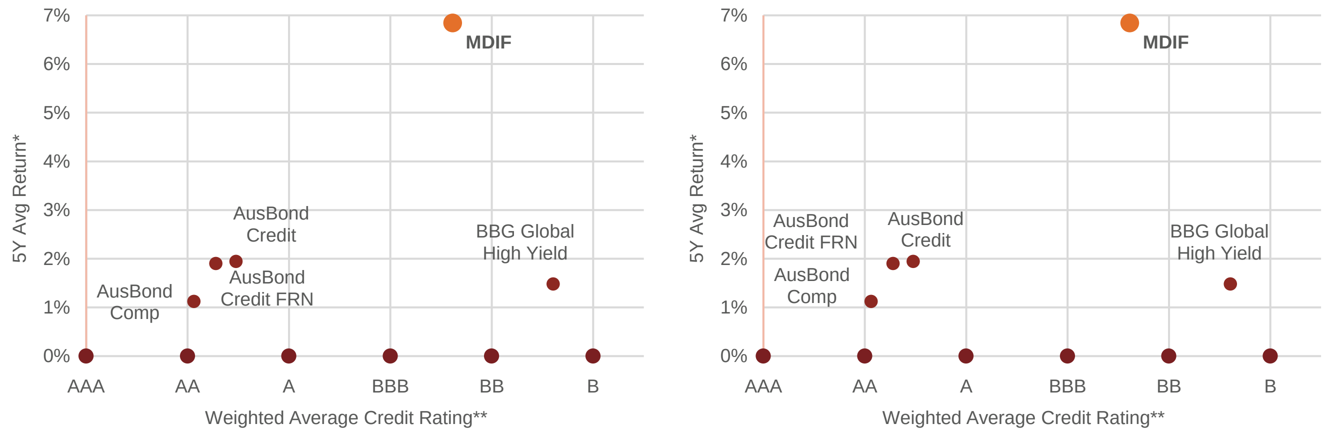
A combination of deteriorating economic conditions and changes in bank regulatory requirements resulting in a higher cost of capital, banks are restructuring capital from certain market segments. This shift has created a wider range of investment prospects for Metrics, as borrowers previously able to satisfy their borrowing needs from traditional bank financing are now compelled to seek alternative capital sources. This change in dynamics has given private credit fund managers like Metrics the ability to replace maturing loans in the underlying portfolio with the most advantageous risk-adjusted return opportunities.

A notable feature of Metrics' performance history is the lack of defaults, a remarkable accomplishment considering the diverse array of counterparties in the portfolio. This success is credited to the adoption of thorough and stringent screening protocols strategically crafted to instil confidence in the complete repayment of a loan before any fund allocation occurs.

Fundamentally, our confidence in Metrics' capacity to maintain effective systems and procedures for minimising credit risk remains strong. The Fund has demonstrated adeptness in structuring loans, effectively mitigating credit risk at both individual loan and portfolio levels. Further risk reduction is achieved through robust diversification, involving 303 distinct counterparties at the portfolio level. Additionally, the Fund also has notably high seniority exposure (90% senior secured loans) on a commitment basis, reinforcing the security of individual investments. These factors synergistically contribute to minimising potential portfolio losses in the event of a counterparty default.

On a standalone basis, MDIF fulfills the criteria for a Recommended product assessment due to its inherent qualities. However, it receives an uncommon upward adjustment for the following reasons: (1) BondAdviser's independent evaluation of the underlying funds; (2) these funds have consistently surpassed their target returns over the past two years; and (3) MDIF doesn't require FX hedging into the WIT or MXT. As a result, given that MXT holds a Highly Recommended rating, MDIF qualifies for a similar assessment. Consequently, we uphold our rarely-assigned 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 September 2023.

Construction and Investment Process

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

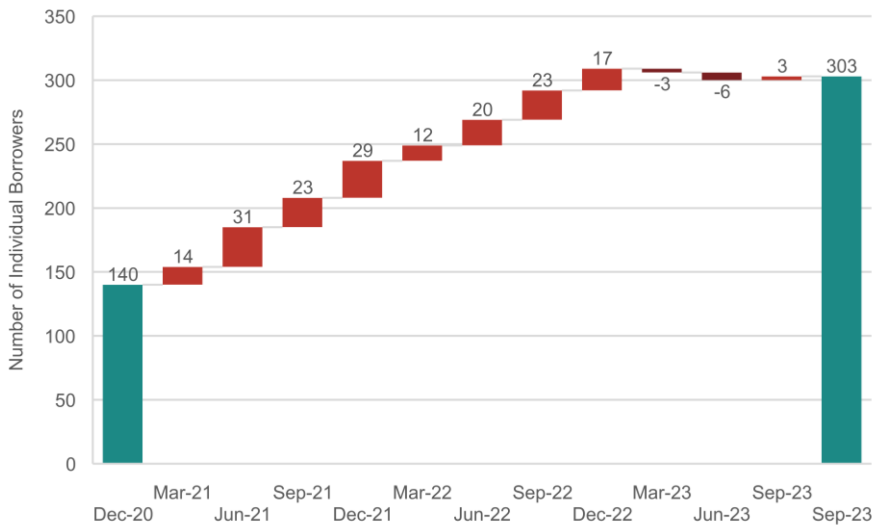
Portfolio Risk Management

At its most basic level, the risk level of a private credit portfolio is determined by the anticipated losses driven by defaults and recovery rates following defaults. We identify three main factors influencing this risk: concentration, credit quality, and seniority, all of which are controlled by the manager. Although there are other risk factors for the portfolio, these three elements are fundamental to private credit funds like MDIF.

Diversification is crucial not only in terms of counterparty and individual loan exposure but also when considering industry exposure and tenor buckets. A more diversified portfolio means the Fund would be less affected by the default of a single counterparty. Two years ago, the portfolio consisted of 324 investments from 185 individual Issuers. Since then, it has expanded to 450 loans and 303 borrowers, indicating overall long-term diversification improvements. Moreover, the mean exposure of individual investments has decreased from 0.28% to 0.23% in the past 24 months, suggesting enhancements in diversification.

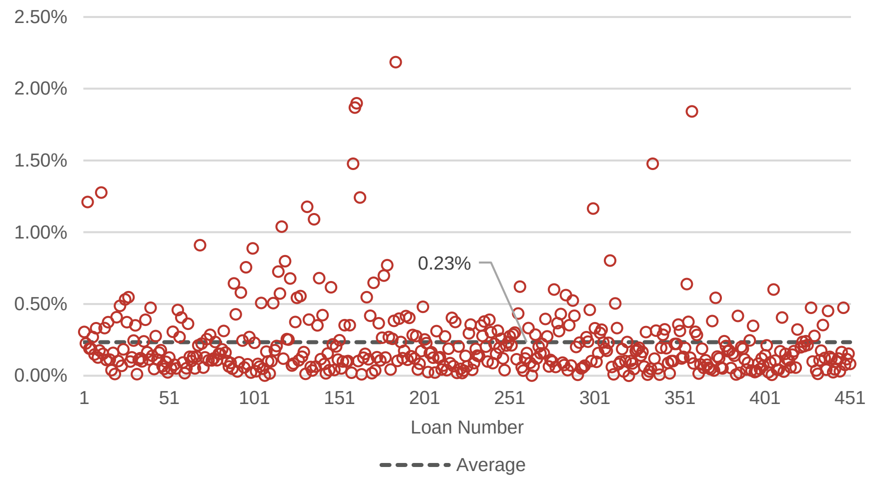
While this is positive in the long run, diversification growth has been constrained recently despite the Manager's perception that there is no lack of deals in the pipeline. Both MXT and MDIF invest in the underlying strategy and since MXT is a closed-ended fund, growth in FUM of the underlying strategy more regularly comes from MDIF's growth. Over the first nine months of 2023, MDIF's FUM grew from $892 million to $1,308 million. On 1 December 2023, MXT completed a wholesale placement raising $196 million. This capital raise together with the proceeds from the subsequent UPP have cemented MXT's position as the largest ASX-listed credit fund. We expect that these funds will be deployed into new deals in the near future as existing loans mature and for at least some of these new deals to drive increases in portfolio diversification.

Figure 5. Unique Borrower Exposure Over Time



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

Figure 6. Individual Loan Exposure*

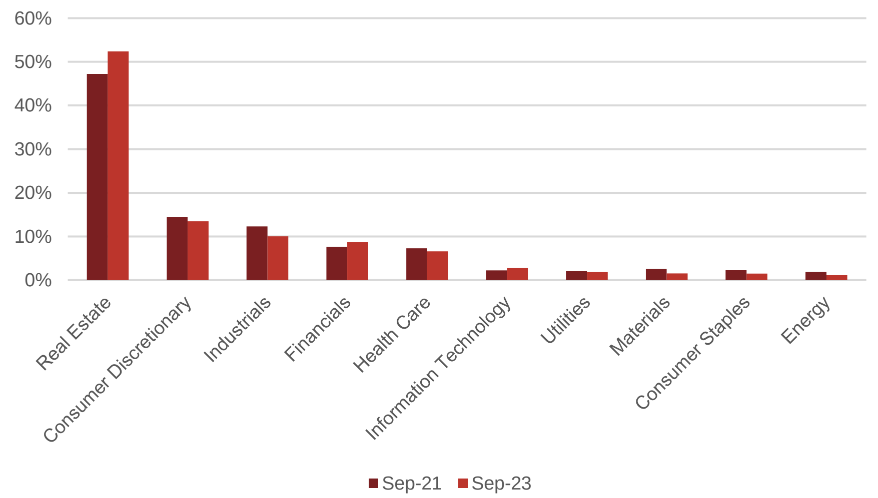


*Source: BondAdviser, Metrics. As at 30 September 2023. *Excluding cash. Based on Metrics' underlying portfolio (WIT) not MDIF.*

Over the past 24 months, MDIF has experienced a material decline in industry diversification as a function of increasing real estate allocation. As of September 30, 2023, 52.4% of the underlying portfolio is allocated to real estate, and 14.5% is devoted to consumer discretionary. This heavy concentration in these two industries is considered a notable weakness in the underlying portfolio. This is deemed a credit negative, as we anticipate potential economic challenges in both sectors in the near future.

It is worth noting, however, that in the last quarter, there was a reduction in the real estate exposure of the portfolio (from 55.4% in June 2023). This positive development in industry diversification is largely offset by an increase in the second-largest exposure - consumer discretionary, another sector we are relatively averse to at this point in the cycle - rising from 12.9% to 14.5% of the portfolio's exposure in the same period.

Figure 7. Portfolio Exposure by S&P Sector*



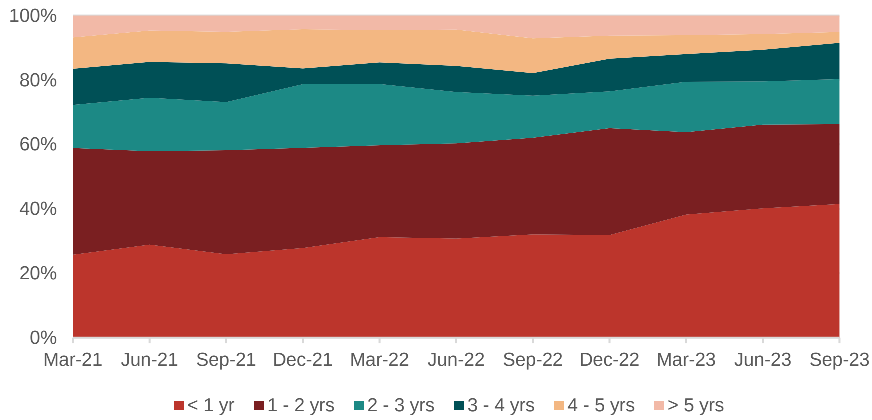
*Source: BondAdviser, Metrics. As at 30 September 2023. * Excluding cash. Based on Metrics' underlying portfolio (WIT) not MDIF.*

Over the past 24 months there has been a continued rise in the allocation to investments maturing in less than a year, increasing from 25.9% as at September 2021 to 41.5%

currently. In the three-month period starting from 30 June 2023, the proportion of investments maturing in less than a year has increased by 1.3 percentage points. The heightened roll-off poses a challenge for the investment team, as an inability to generate sufficient new loans may lead to an accumulation of excess cash, potentially impeding returns.

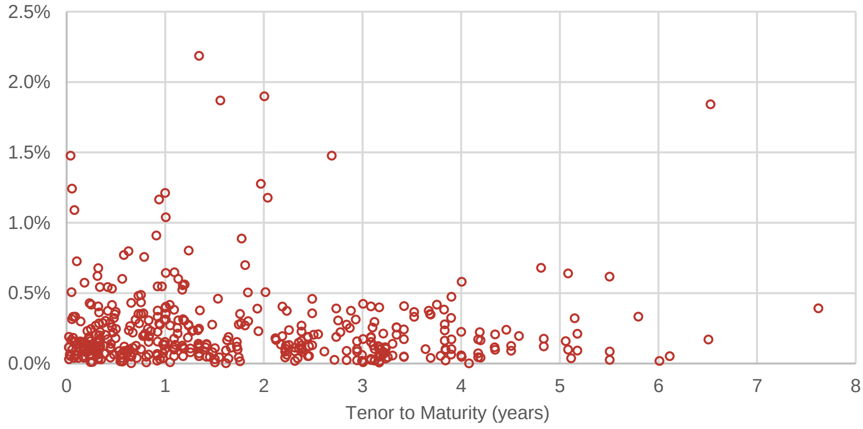
This could potentially be regarded as credit negative, as it is a significant allocation to a singular tenor bucket and inherently indicates limited diversification in that sense. However, the Metrics manager has historically demonstrated proficiency in effectively recycling capital without any adverse consequences, such as compromising the portfolio's credit quality or returns. Additionally, targeting loans with shorter tenor is part of Metrics' strategy as it both reduces credit risk and increases portfolio churn, which flows onto higher fees. These factors drive better risk adjusted returns for investors. Therefore, we have confidence that Metrics will continue to build on this successful track record, and it is not cause for major concern.

Figure 8. Portfolio Loan Tenor Mix*



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

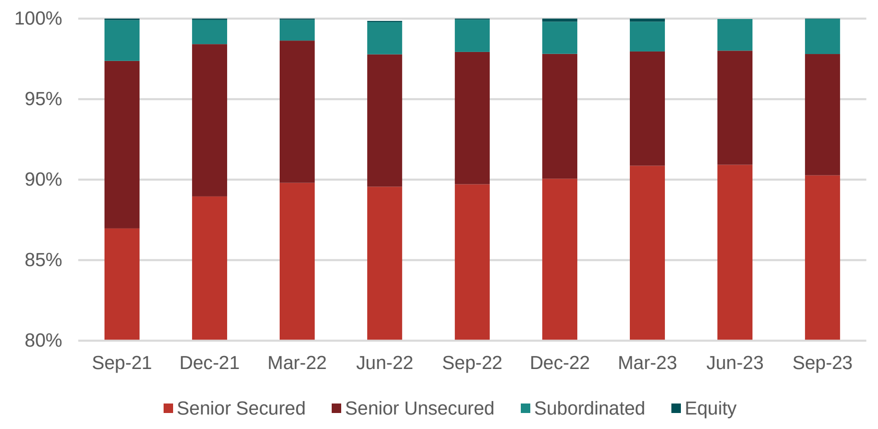
Figure 9. Individual Loan Exposure by Tenor to Maturity*



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

Historically, the seniority of the underlying portfolio has displayed a positive trend. The substantial emphasis on first lien loans and the diversification of counterparties stands out as a significant overall positive for risk reduction compared to the portfolio composition 24 months ago. First lien loans provide investors a higher expected recovery in the event of default, ultimately reducing the downside risk of the portfolio in the event of default.

Figure 10. Portfolio Seniority Mix*

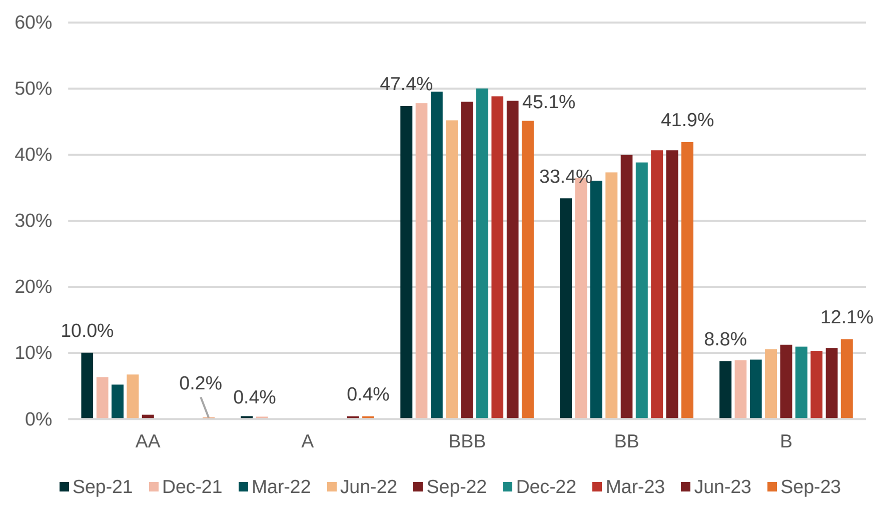


*Source: BondAdviser, Metrics. As at 30 September 2023. *Excluding cash. Based on Metrics' underlying portfolio (WIT) not MDIF.*

Using September 2021 as a baseline, the underlying portfolio's credit mix has seen slight deterioration. This is a function of the increased allocation to sub-investment grade loans from 42.2% to 53.2% as at 30 September 2023. Despite the negative shift in the portfolio's weighted average credit rating having caused a weakening in the portfolio's creditworthiness, the manager's successful track record in handling loans provides reassurance for investors. This is an anticipated outcome due to the increased FUM. In such a scenario, the Fund expects a lack of investment-grade opportunities to invest in.

As of 30 September 2023, BBB-rated allocations remain robust at 45.1%, showing a decrease of -3.1 percentage points compared to the preceding three months, and only a 2.3 percentage point decrease when compared to 24 months prior.

Figure 11. Portfolio Credit Rating Mix*

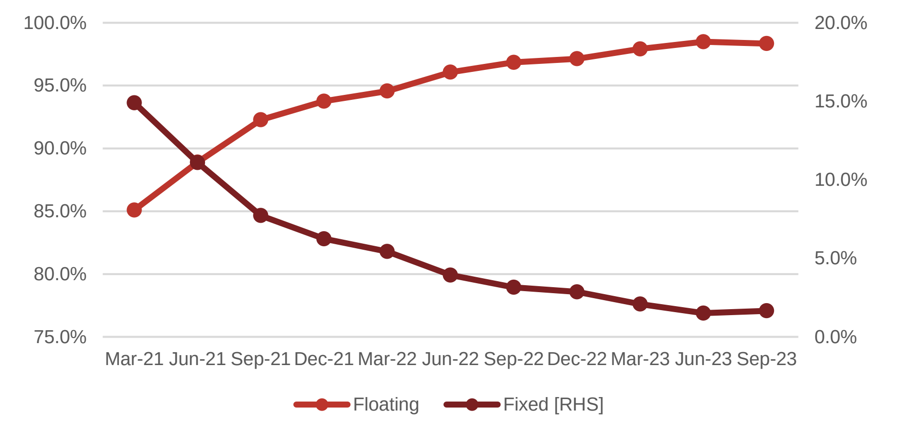


*Source: BondAdviser, Metrics. As at 30 September 2023. *Excluding cash. Based on Metrics' underlying portfolio (WIT) not MDIF.*

While the Fund's underlying portfolio remains largely immune to interest rate risk (duration) due to the prevalence of floating rate investments, it is crucial for investors to remain vigilant in a rising interest rate environment. Higher risk of default emerges as borrowers are required to meet increasing interest obligations. Given that 98.3% of the portfolio consists of floating rate assets, there is a potential for increased concerns about the creditworthiness of counterparties and as a consequence, the likelihood of defaults.

It is worth noting that, given the current stage of the economic cycle, further increases in interest rates are unlikely. Instead, it is more probable that the economy will shift towards expansion in the near future, leading to a potential reduction in returns on floating rate securities.

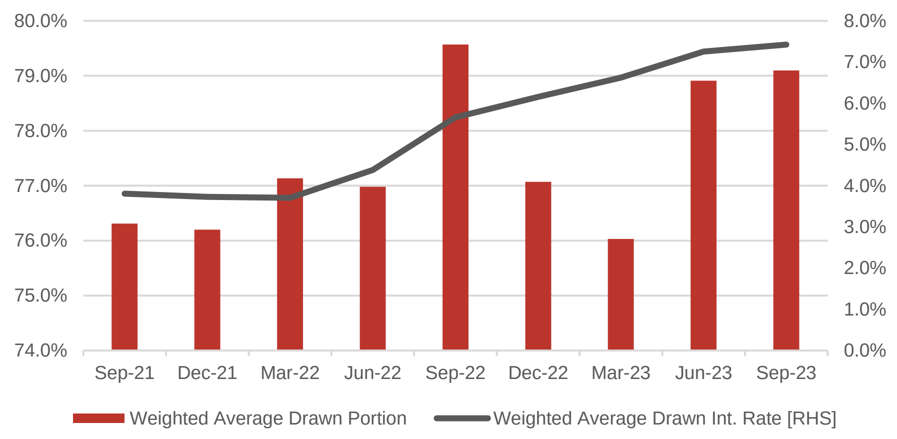
Figure 12. Portfolio Loan Interest Payment Mix*



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

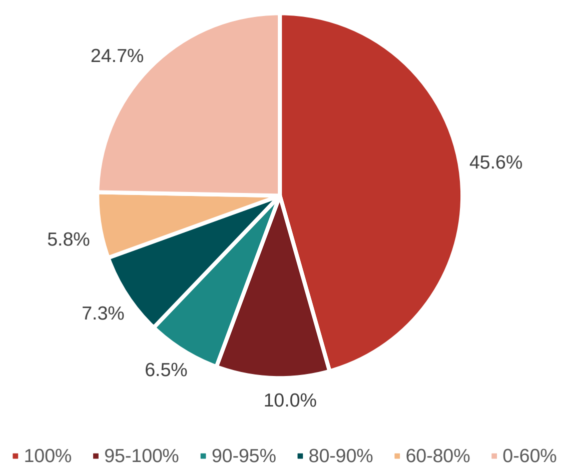
An intriguing aspect of MDIF's portfolio lies in the portfolio's drawn portion. Typically, in the face of a deteriorating economy, businesses often require additional cash to sustain operations. However, in MDIF's underlying portfolio, the prevailing economic downturn has not significantly affected the Fund's portfolio, reflective in the substantial 20.9% in unutilised funds on a committed basis.

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



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

Figure 14. Portfolio Weighted Average Drawn Portion and Interest Rate*

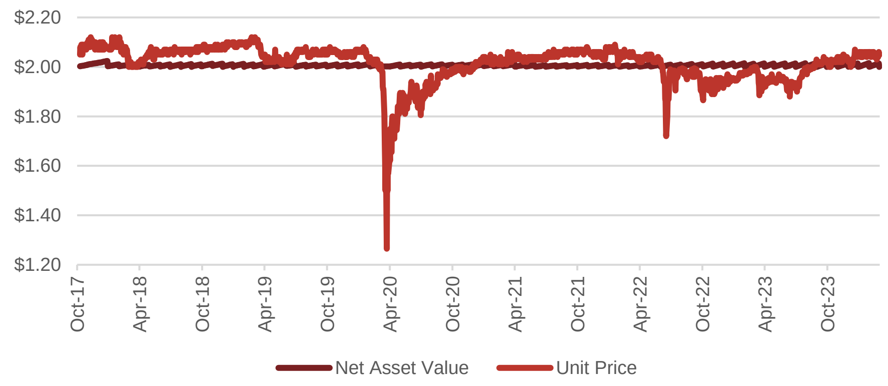


*Source: BondAdviser, Metrics. As at 30 September 2023. *Excluding cash. Based on Metrics' underlying portfolio (WIT) not MXT.*

Fund Governance

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

Figure 15. MXT Net Asset Value Against Unit Price



Source: BondAdviser, Metrics, Bloomberg. As at 1 March 2024.

MDIF possesses the capability to invest either in WIT or directly in units of Metric's ASX-listed fund, MXT. As of September 30, 2023, MDIF has allocated 5.7% to MXT, thereby exposing the unlisted fund to fluctuations in the listed market. While this exposes MDIF to a risk that conventional unlisted fund investors actively try to avoid, such market fluctuations also create an opportunity for MDIF. By acquiring units of MXT at a significant discount to NAV (e.g., as observed in June 2022 with a discount of around 14%), MDIF can capitalise on any subsequent appreciation in unit price as MXT approaches its NAV. The discount gap was closed after approximately 14 months on August 28, 2023, with MXT most recently trading at a 2.5% premium to NAV as of the close on 29 February 2024. Therefore, now is the time we would expect MDIF to consider reducing exposure to MXT as it is trading above its net asset value.

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

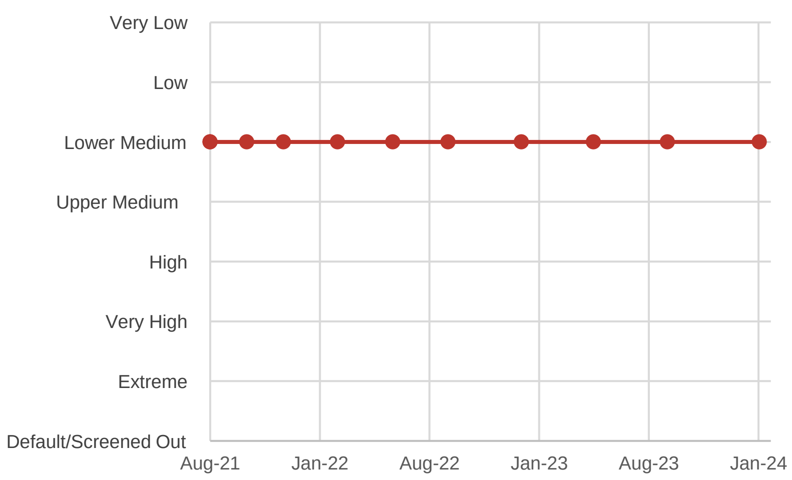
MDIF's underlying portfolio has shown slight deteriorations versus the previous simulations as at 30 June 2023 in both the benign and the stressed scenario. Although that is the case, the portfolio still highlights the ability to protect investor capital against downside environments whilst delivering strong returns within a blue-sky backdrop. An important factor within credit portfolios is concentration, specifically exposure to individual counterparties. As diversification is an essential pillar to preserving capital, MDIF's continued improvements to diversification has resulted in uplifts to its modelled outcomes in our *Quantitative Analysis*. The Fund has slightly increased its counterparty diversity from 292 in September 2022, to 303 as at September 2023. These positive diversification benefits have been entirely offset by the tilt towards lower credit rated borrowers. As such, the modelled performance has not seen much change within adverse conditions. The median capital returns in our stressed scenario are -1.05%, which is a slight deterioration from three months ago at -0.96%.

Over the past three months, investment-grade loan weights have decreased by 3 percentage points. Credit quality plays an integral role when structuring a credit portfolio, for which the shift towards lower rated investments represents a negative influence on capital protection. The high level of diversity on an individual investment basis counters this, driving positive defensive properties in the modelled outcomes. The 99% VaR in stressed conditions simulated a capital return of -2.98%, indicating only 1% of simulations in a GFC-like environment resulted in a capital loss worse than -2.98%.

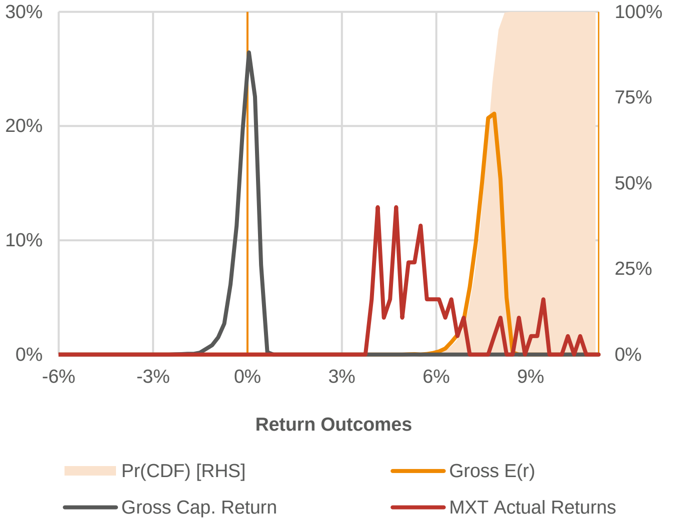
In our benign scenario, the portfolio saw far stronger simulations versus the previous experience. The mean gross expected returns increased 0.57 percentage points to 7.51% over the past three months as a result of increased sub-investment grade loans. The 99% VaR has increased 0.44 percentage points in the same time frame.

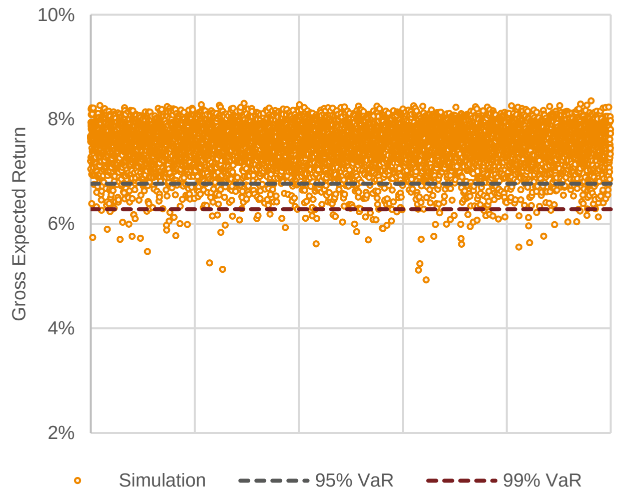
The strategic changes within MDIF's portfolio relative to credit risk are a double-edged sword. While the slight shift in credit quality benefits the outcomes within the benign simulations, the defensive properties of the book are slightly lessened. The maintained high level of counterparty diversification bolstered by the robust outcomes in our portfolio simulation underscores our risk score of **Lower Medium** or "A", a credit rating notch above the weighted average credit profile.

Figure 16. Risk Score



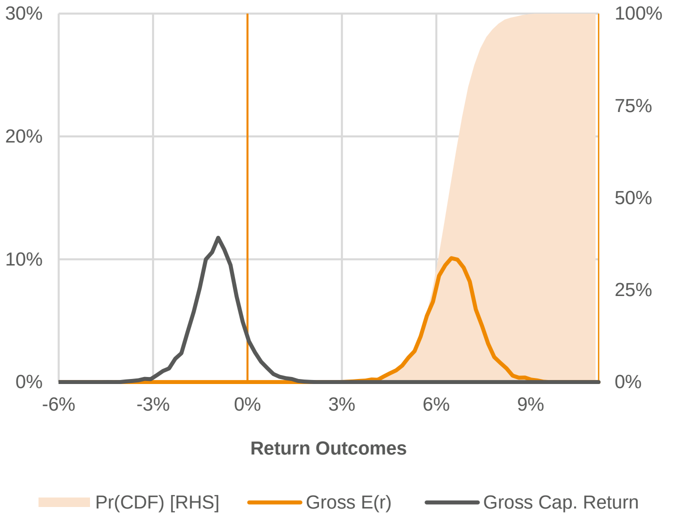
Scenario 1. Baseline Asset Assessment

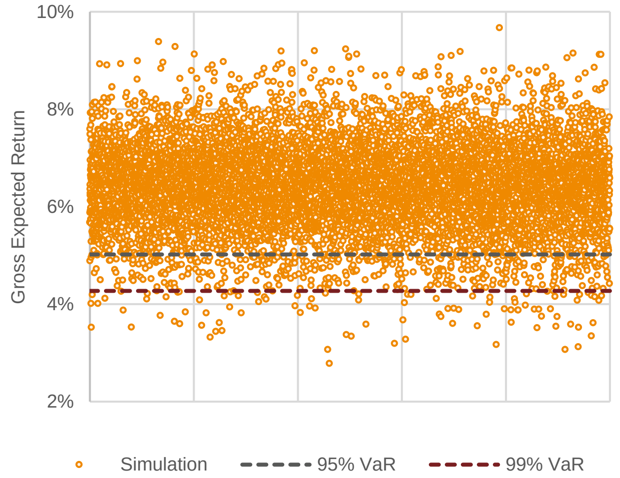




Source: BondAdviser Estimates as of 30 September 2023 portfolio. Excludes impact of management and origination fees. Gross capital returns excludes the value of coupons/income and is only modelling impairment or loss given default, based on historical credit data from Moody's. Impact of traded price 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 September 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 – 3 January 2024

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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Report created on 4 March 2024.