Fund Research

Metrics Direct Income Fund

Overview

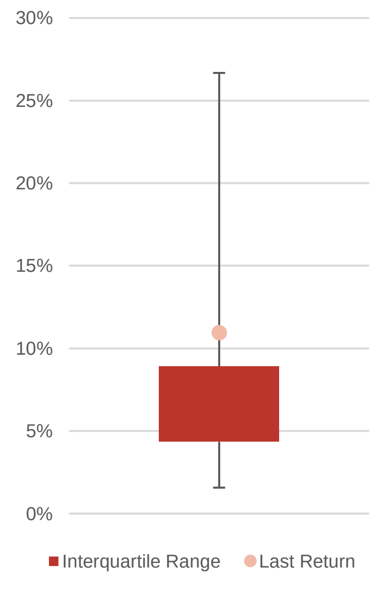
The Metrics Direct Income Fund ("MDIF", or the "Fund") is an unlisted open-ended unit trust domiciled in Australia that provides retail investors with access to the Australian corporate loan market. The Fund gains such exposure across the credit risk spectrum via investment in wholesale funds managed by Metrics. Previously, this sub-asset class of the Australian debt market had been restricted to major banks and institutional investors. As such, MDIF breaks down this barrier allowing retail investors to gain exposure to an investment that is otherwise not directly accessible to them.

Metrics has a very similar fund to MDIF that is listed on the ASX, the "Metrics Master Income Trust" (ASX: MXT), which was listed on the ASX in October 2017. MDIF's purpose is to provide an alternative investment vehicle to MXT for investors who wish for greater redemption certainty (MDIF units are redeemed at NAV – as compared to selling at the traded unit price of MXT), whilst providing the same exposure as MXT's underlying portfolio. Furthermore, while MDIF does not have direct unit price risk like MXT, MDIF has the ability to hold MXT units which does bring some of this risk to the Fund.

MDIF's objective is to provide stable capital value whilst achieving an attractive income stream, with a target return of the **RBA cash rate plus 3.25% p.a.** (currently 7.60% p.a.) **after fees**, payable monthly.

MDIF invests in the MCP Wholesale Investment Trust (WIT) in which, the WIT invests in Metrics' wholesale investor funds. Both MDIF and MXT invest in the WIT, however, MDIF can also hold units of MXT.

Figure 1. Monthly Net Returns Box Plot



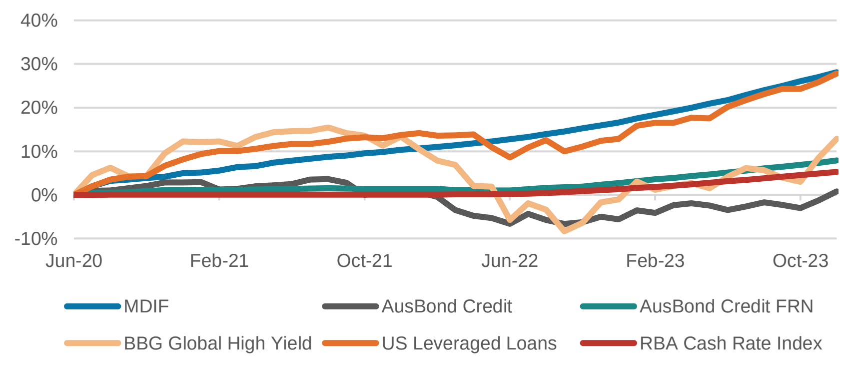
Source: BondAdviser, Metrics. Annualised monthly returns, after fees since inception. As at 31 December 2023.

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	0.88	0.76	0.87	**9.48**
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 31 December 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 December 2023. Calculated from cumulative net monthly returns of the Underlying Fund. Returns on NAV, not traded unit price.

Product Assessment

Highly Recommended

While little has changed in the underlying portfolio over the past year, MDIF remains well positioned to continue providing investors strong risk-adjusted returns.

MDIF offers retail investors access to the domestic commercial lending market, primarily through senior secured, floating rate loans to both investment grade and sub-investment grade companies and projects. It is an unlisted, open-ended fund that primarily invests in the MCP Wholesale Investment Trust (WIT), with the option to also invest in the Metrics Master Income Trust (ASX: MXT), which exclusively invests in the WIT. WIT, in turn, invests in three wholesale funds managed by Metrics, with approximately 60% allocated to the Metrics Credit Partners Diversified Australian Senior Loan Fund (DASLF), ~20% to the MCP Secured Private Debt Fund II (SPDF II), and ~20% in the MCP Real Estate Debt Fund (REDF).

MDIF is suitable for investors seeking low capital volatility and an attractive monthly income from a diversified portfolio of domestic private credit. Additionally, it offers diversification benefits due to the low correlation of private debt to traditional asset classes like equity and fixed income (bonds).

The Fund is highly diverse with predominantly senior secured exposures at the crossover of investment grade. This strategy is producing consistent income well above its returns target and we foresee this continuing.

The Fund continues to meaningfully outperform its target return of the RBA Cash Rate +3.25% across all timeframes. On a rolling-basis for the last 12 and 24 months to 31 December 2023, the Fund has returned 9.89%, and 7.76% p.a (net assuming reinvestment of distributions) since inception. This is 258bps and 183bps above the Funds target returns over the last one and two years, respectively.

As an unlisted fund, MDIF should be relatively insulated from unit price fluctuations (despite its small exposure to MXT), a feature that largely shields it from the volatility experienced by listed funds, especially during market downturns. This was evident in June 2022, when a market sell-off caused a disconnection between the unit price and NAV of listed funds, including MXT. MXT's unit price did not realign with its NAV until 28 August 2023, after about 14 months of divergence. Despite this, MXT continues to trade above NAV, having completed a wholesale placement on 1 December 2023, raising $196.4 million at $2.00 per unit and a Unit Purchase Plan raising a further $76.1 million after closing on 30 January 2024. There have also recently been Wholesale Placements raising $31.0 million and $47.5 million. This is advantageous for MDIF investors, as MXT shares the same investment strategy. The increase in funds under management (FUM) by approximately $351 million is expected to enhance diversification benefits in the underlying portfolio, reducing downside risk for investors.

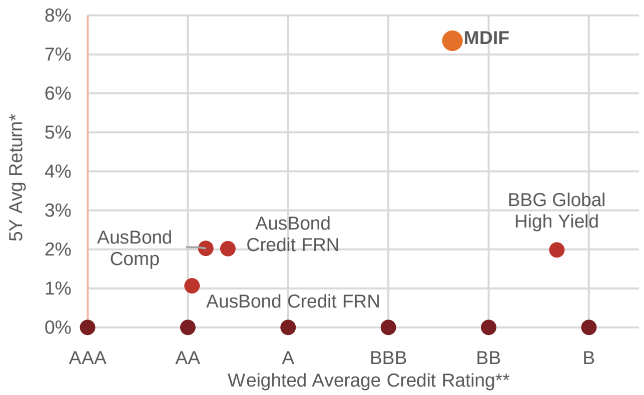
While the underlying portfolio is predominantly composed of floating rate investments, fluctuations in interest rates can still impact the portfolio's returns. When rates increase, borrowers may struggle to meet repayments, increasing the risk of default and potentially lowering their creditworthiness. It is also important to note MDIF’s significant allocation to real estate exposure, comprising 51% of the underlying portfolio, a weight that has been consistent for the past two years. Nevertheless, many of the real estate loans are senior secured, offering a high level of protection against defaults or losses as opposed to equity or mezzanine financing.

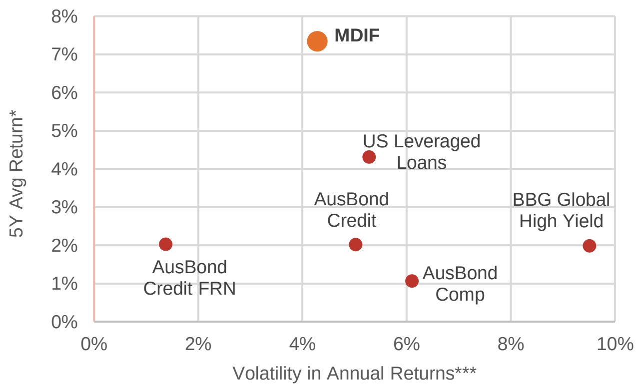
Recent debates and changes in bank regulatory requirements have led to higher capital requirements. This has expanded the Manager's pipeline of opportunities, as stricter borrowing guidelines force eligible borrowers to seek financing elsewhere. This environment has benefitted private credit fund managers like Metrics, providing more favourable risk-adjusted return opportunities and reducing the need to constantly reinvest short-term investments maturities.

Metrics boasts an impressive track record, having experienced no losses impacting investor returns despite diverse range of counterparties invested in across its decadelong history. This success can be attributed to rigorous screening protocols that are designed to instil confidence in full repayment before funds are allocated. As such, our confidence in Metrics' ability to maintain effective systems and procedures to minimise credit risk remains strong. The Fund has demonstrated skill in structuring loans to reduce credit risk while emphasising diversification, with 301 unique counterparties in the portfolio. Additionally, 90.8% of the portfolio is senior secured on a drawn basis excluding cash, further enhancing the safety of individual investments. These risk mitigation factors work together to fortify the portfolio against potential losses in the event of a counterparty default.

MDIF would typically receive a Recommended product assessment on its own. However, it earns an uncommon upwards notching due to three key factors: (1) individual assessments by BondAdviser of its underlying funds, (2) these funds consistently surpassing target returns over the past rolling two-year periods, and (3) no need for hedging MDIF's FX exposure into WIT or MXT. Thus, with MXT holding 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 31 December 2023.

Construction and Investment Process

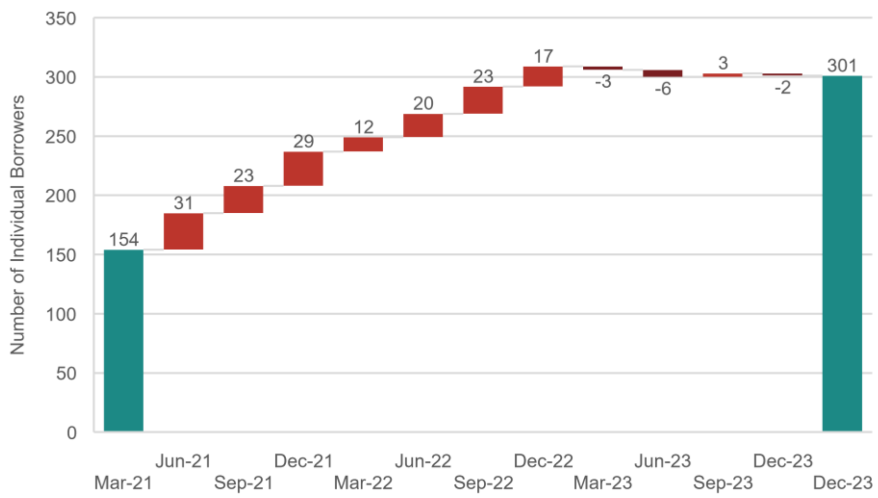
There have been **no material changes** to MDIF's construction and investment process.

Portfolio Risk Management

At its core, the risk of a private credit portfolio is determined by expected losses, which result from defaults and recovery rates post-default. We believe that the risk of a credit portfolio can be managed through three key factors under the control of a portfolio manager: concentration, credit quality, and seniority. These factors can be adjusted to tailor the risk profile of the portfolio.

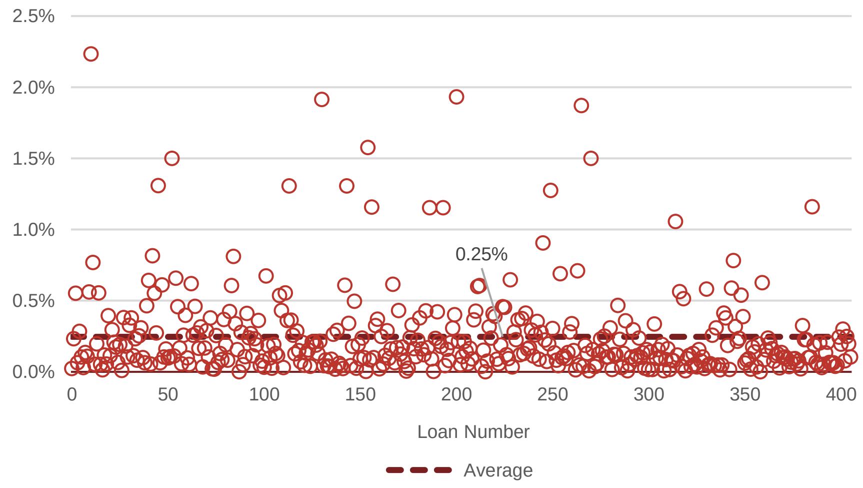
Diversification plays a crucial role in managing risk within a portfolio, both at the counterparty level and for individual investments. Increased diversification reduces the impact of a single default on the overall portfolio. Over the past year, there has been a temporary pause in short-term diversification, with the portfolio reducing unique counterparties by eight, decreasing from 309 to 301 as at December 31, 2023. The average exposure of individual investments has increased from 0.23% to 0.25% over the last quarter, reflecting the fewer individual investments held within the portfolio. However, over the longer term, the portfolio has significantly improved its diversification, adding 64 unique counterparties over the 24 months to 31 December 2023. Despite the counterparty consolidation after a period of rapid growth, diversification remains a strong point of the Fund.

Figure 5. Unique Borrower Exposure Over Time



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

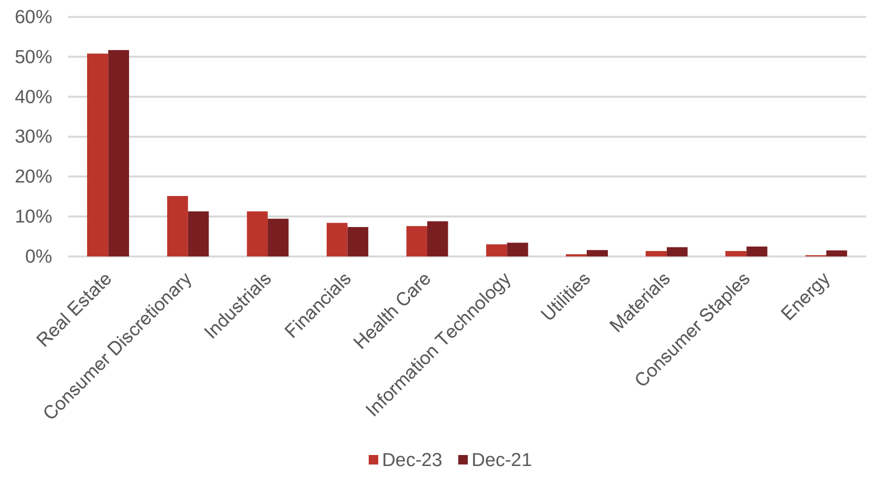
Figure 6. Individual Loan Exposure*



*Source: BondAdviser, Metrics. As at 31 December 2023. *Based on the drawn value of commitments and excluding cash. Based on Metrics' underlying portfolio (WIT) not MDIF.*

In the 24 months from December 2021, MDIF's underlying industry diversification has seen a minor decline, a reflection of the increased weighting to real estate exposure, which was 50.8% on a drawn basis and excluding cash as at 31 December 2023. Additionally, this marks a 24-month consecutive streak of real estate consisting of at least one half of the portfolio on a commitment basis. The heavy concentration to a single sector is seen as a noteworthy weakness within the portfolio. This is because of the benefits of a highly diversified portfolio by number of individual tranches (452) is offset by a high level of expected intra-industry correlation in a market-wide downturn.

Figure 7. Portfolio Exposure by S&P Sector*



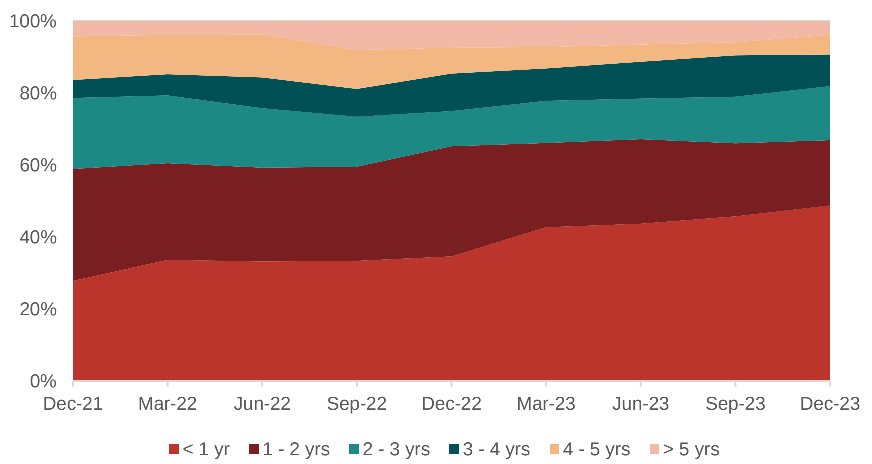
*Source: BondAdviser, Metrics. As at 31 December 2023. *Based on the drawn value of commitments and excluding cash. Based on Metrics' underlying portfolio (WIT) not MDIF.*

An increasing concern for MDIF's underlying portfolio is the continued increase in allocation to investments maturing in less than a year. Over the past 24 months, allocations with less than a year remaining has increased by 21 percentage points to 48.8% of the drawn portfolio excluding cash. Additionally, over the three-month period from 30 September 2023, the weighting on such investments has increased by 3.0ppts.

This increase is a significant challenge for the Metrics team, given the failure to generate new loans could lead to an excess of cash which may impede returns. Notably, the cash balance has increased from 0.06% to 0.21% to 0.42% at the end of the past three quarters, indicating that there may be a challenge in rolling over into new loans.

We observe that the Manager considers this as part of its strategy, as increased portfolio turnover leads to higher fees for investors, and shorter tenors mitigate credit risk. These elements contribute to enhanced risk-adjusted returns. With its established track record and expanding pipeline, we expect Metrics to continue to successfully rollover these investments.

Figure 8. Portfolio Loan Tenor Mix*



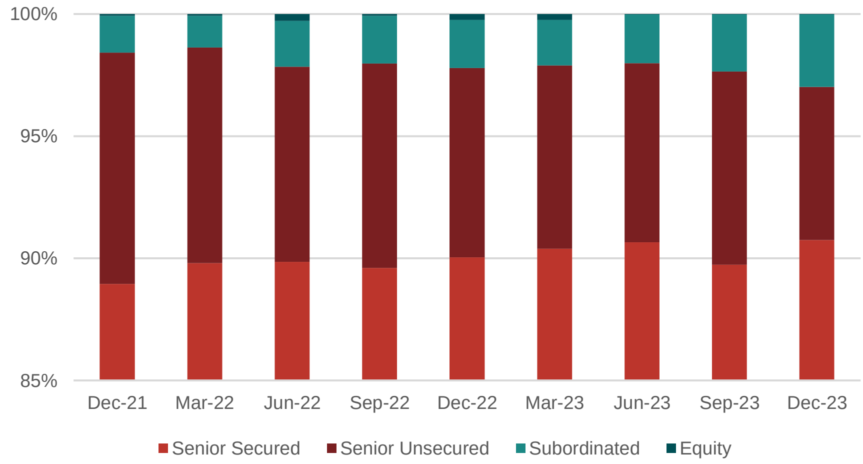
*Source: BondAdviser, Metrics. As at 31 December 2023. *Based on the drawn value of commitments and excluding cash. Based on Metrics' underlying portfolio (WIT) not MDIF.*

Figure 9. Individual Loan Exposure by Tenor to Maturity*

*Source: BondAdviser, Metrics. As at 31 December 2023. *Based on the drawn value of commitments and excluding cash. Based on Metrics' underlying portfolio (WIT) not MDIF.*

The seniority composition within the underlying portfolio has shown minimal alteration over the last 12 months, particularly in terms of senior secured positions, which have strengthened by 72 basis points to 90.75% on a drawn basis excluding cash. Notably, there has been a rising trend in subordinated investments, particularly since the last quarter, with allocations increasing from 2.34% to 2.96% during this period. The predominantly senior secured nature of the portfolio offers reassurance to investors, as in the event of default, repayment of the Fund's investment would be first priority and the Fund would hold a claim over assets of the defaulting company or project.

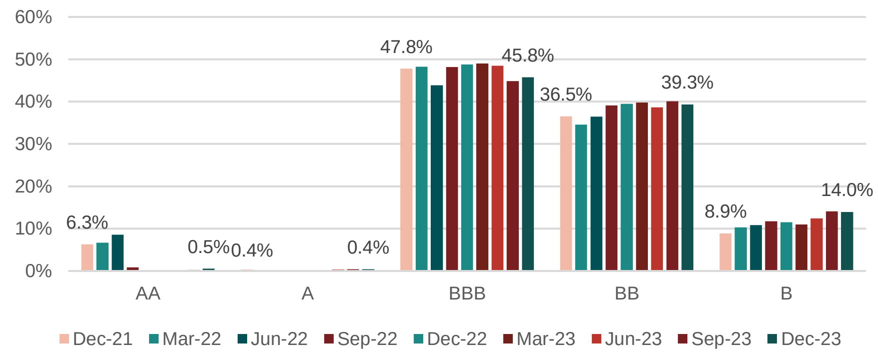
Figure 10. Portfolio Seniority Mix*



*Source: BondAdviser, Metrics. As at 31 December 2023. *Based on the drawn value of commitments and excluding cash. Based on Metrics' underlying portfolio (WIT) not MDIF.*

The composition of credit ratings has remained relatively consistent compared to three months prior, with the notable change being the rise in AA-rated investments due to slightly increased cash holdings. However, there has been a gradual transition towards sub-investment grade assets in the underlying portfolio over the long term. From December 2021 to December 2023, the weighting to sub-IG investments has grown by 7.8 percentage points on a drawn basis.

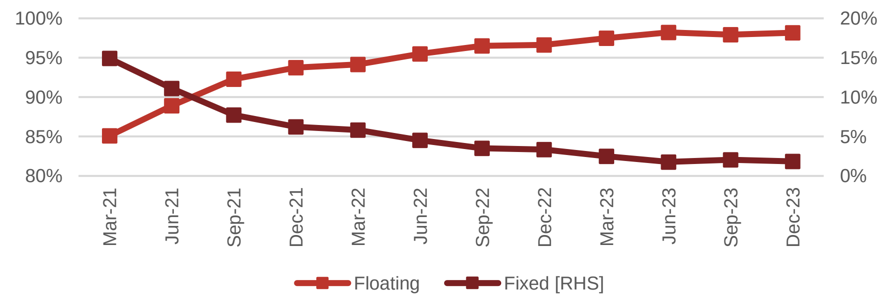
Figure 11. Portfolio Credit Rating Mix*



*Source: BondAdviser, Metrics. As at 31 December 2023. *Based on the drawn value of commitments and including cash. Based on Metrics' underlying portfolio (WIT) not MDIF.*

The underlying portfolio of MDIF is largely made up of floating-rate investments at 98.2% on a drawn basis and excluding cash. This reduces the prevalence of interest-rate risk (duration). However, investors must still be cautious of the possible implications of rising interest rates, as higher rates lead to higher repayment obligations for debtors, which inherently leads to greater default risk. Of its outstanding loans by drawn value and excluding cash, 36.9% were originated prior to 2022. While Metrics has not experienced a default, this is cause for concern given over a third of the book would be paying significantly higher payments than were originally expected when the loan agreement was entered into. Then-Governor Phillip Lowe stated that there would be no rate hikes until 2024 and these borrowers have since absorbed seventeen 25 basis point hikes. This drastically elevates the risk of default as higher interest payments are met. Positively for these borrowers and therefore the credit risk in the Fund, markets are pricing in RBA Cash Rate cuts in the second half of 2024. We do note that a lot of older loans would have been repriced or extended since their initial origination date.

Figure 12. Portfolio Loan Interest Payment Mix*

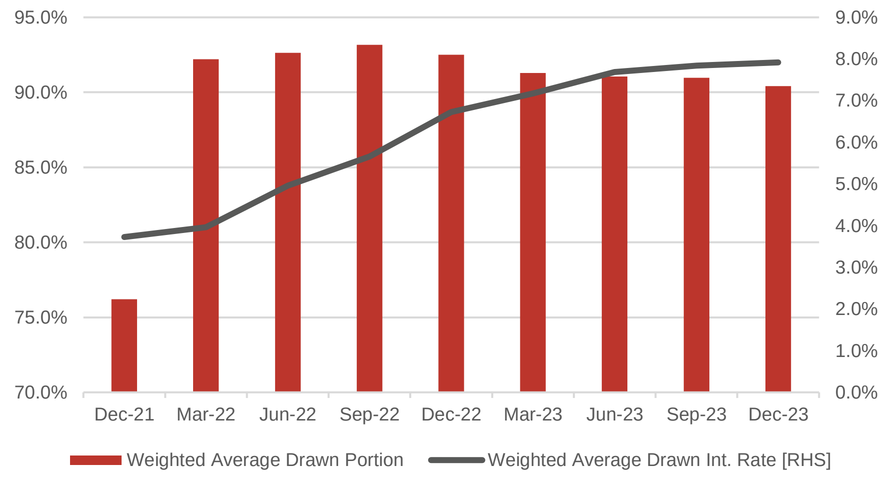


*Source: BondAdviser, Metrics. As at 31 December 2023. *Based on the drawn value of commitments and excluding cash. Based on Metrics' underlying portfolio (WIT) not MDIF.*

Based on the drawn value of commitments and excluding cash, 52.3% of the underlying portfolio was fully drawn as at 31 December 2023. Three months ago, 57.7% of the portfolio was fully drawn. During periods of increased economic stress, businesses often retain more cash to mitigate operational uncertainties. The fully drawn portion of the portfolio has decreased by 5.6 percentage points and the weighted average drawn portion has seen a slight decrease by 0.6 percentage points.

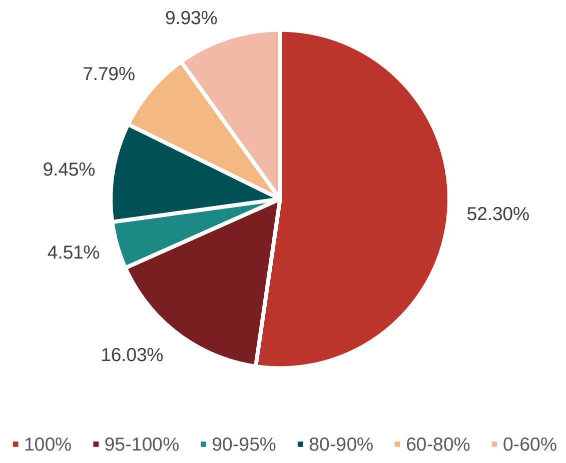
Interestingly, over the past five quarters, the weighted average drawn portion of the portfolio has been lower than the prior period. That said, there was a significant spike following the December 2021 quarter which reflects our anticipation of continued economic weakening, potentially leading more of MDIF's portfolio companies to tap into available cash reserves. Consequently, a pressing concern arises regarding whether the existing cash reserves of these companies will be adequate to navigate through challenging operating conditions.

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



*Source: BondAdviser, Metrics. As at 31 December 2023. *Based on the drawn value of commitments and excluding cash. Based on Metrics' underlying portfolio (WIT) not MDIF.*

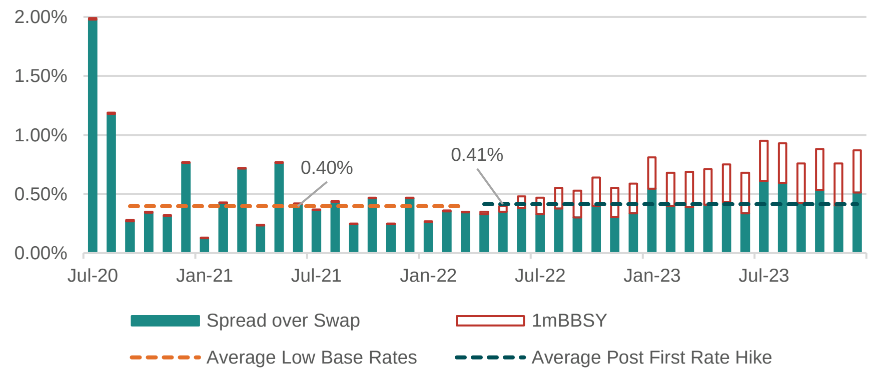
Figure 14. Portfolio Weighted Average Drawn Portion and Interest Rate*



*Source: BondAdviser, Metrics. As at 31 December 2023. *Based on the drawn value of commitments and excluding cash. Based on Metrics' underlying portfolio (WIT) not MXT.*

Between April 2020 and April 2022, the RBA cash rate was near zero, at either 0.25% or 0.10%. MDIF was incepted in July 2020 at a time when MXT was trading at a significant discount to NAV and the newly established Fund was able to invest in these discounted units and realise capital returns. Excluding the first two months of MDIF's history, the Fund is largely delivering the same returns as it was prior to the first cash rate hike. This is a reflection of the consistent credit exposure and predominantly floating rate nature of the underlying holdings along with the lack of equity-like securities in the portfolio (that would not earn regular interest income but would hopefully be remarked higher at a later date).

Figure 15. Breakdown of MDIF Monthly Net Returns

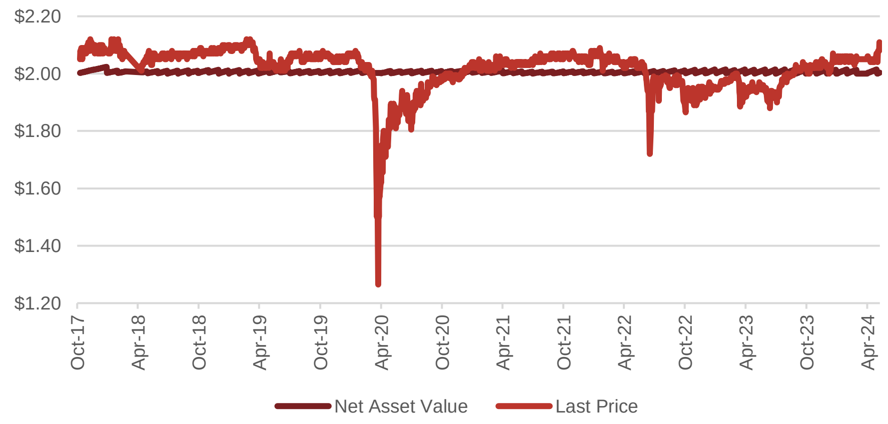


Source: BondAdviser, Metrics. As at 31 December 2023.

Fund Governance

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

Figure 16. MXT Net Asset Value Against Unit Price



Source: BondAdviser, Metrics, Bloomberg. As at 8 May 2024.

MDIF has the option to invest in either WIT or directly in units of Metrics' ASX-listed fund, MXT. As at 31 December 2023, MDIF had allocated 4.8% to MXT, exposing the unlisted fund to fluctuations in the listed market. This gives MDIF a risk weighting that we believe unlisted fund investors typically wish to avoid, but it also presents an opportunity for MDIF. By acquiring units of MXT at a significant discount to NAV (for example, observed in June 2022 with a discount of around 14%), MDIF can benefit from any subsequent appreciation in unit price as MXT approaches its NAV. The discount gap closed after approximately 14 months on 28 August 2023, and MXT has continuously traded at premium to the NAV since (4.8% premium as at 8 May 2024). There has been a gradual unwinding in the MXT position over the past few quarters since the units began trading above NAV and we would prefer to see this completely zeroed while units continue to trade above NAV. Not only does this crystalise capital upside returns to MDIF holders, it also removes the downside risk discussed above. Should MXT fall below NAV again, then we would be supportive of such a holding, however until that point, the slight weighting to a more volatile asset than its underlying holdings seems unnecessary.

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

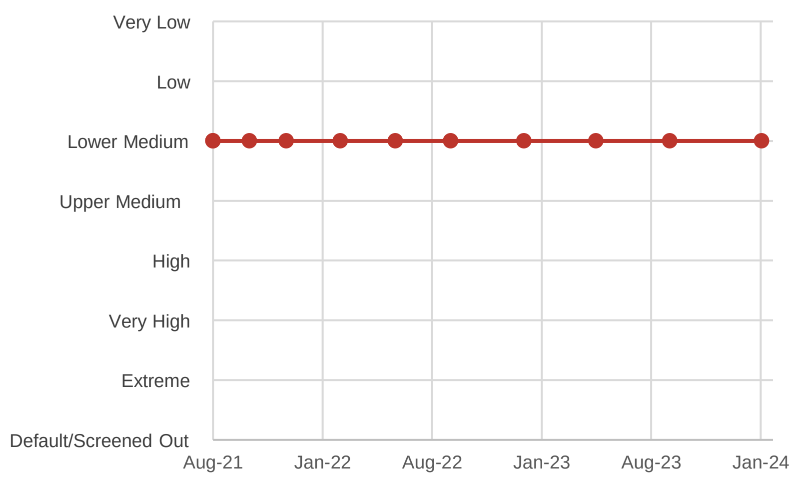
The portfolio has demonstrated enhanced downside protection within stressed environments over the past three months since our last simulations, alongside continued robust returns in benign market conditions. Diversification is crucial in structuring a credit portfolio, and the lack of change in counterparty diversification has meant the portfolio's improvements are driven by changes to its credit and seniority allocations. This was done so via the Fund's slight shift towards lower credit risk investments, an increase in cash holdings as well as a higher proportion of senior secured loans.

In our stressed environment scenario, median capital returns have improved by 28 basis points (bps) to -0.77%. This improvement is mainly due to a 60bps increase in allocation to Investment Grade assets and an increase in the cash balance, which rose from 0.21% to 0.42%. A greater cash balance adds a safeguard in a GFC-like environment as cash held will not face a capital loss whereas a loan might. On the other hand, in our benign scenario, a high cash balance would drag modelled returns lower as the uninvested capital does not earn income. Additionally, the 99% VaR in stressed conditions simulated capital returns of -2.92%, indicating that only 1% of simulations within a GFC like scenario resulted in capital losses worse than -2.92%, a 6-basis point increase over the past three months.

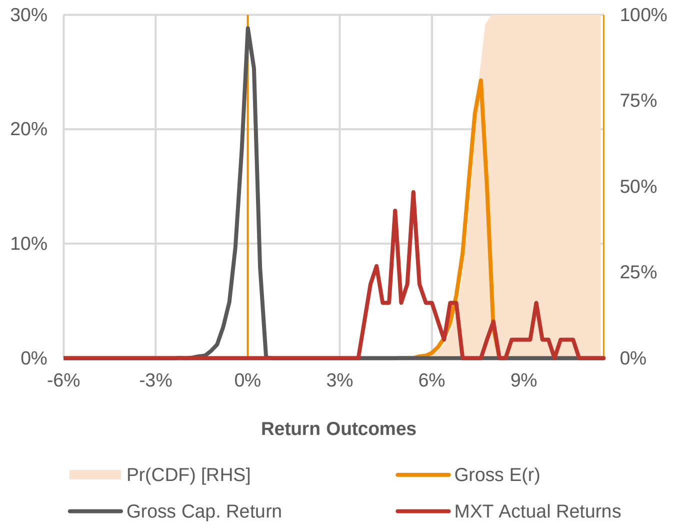
In our benign scenario, the underlying portfolio remained relatively stable, with mean returns increasing by 9bps to 7.68% over the same period. The 99% VaR also remained largely unchanged, with a 6bps decrease.

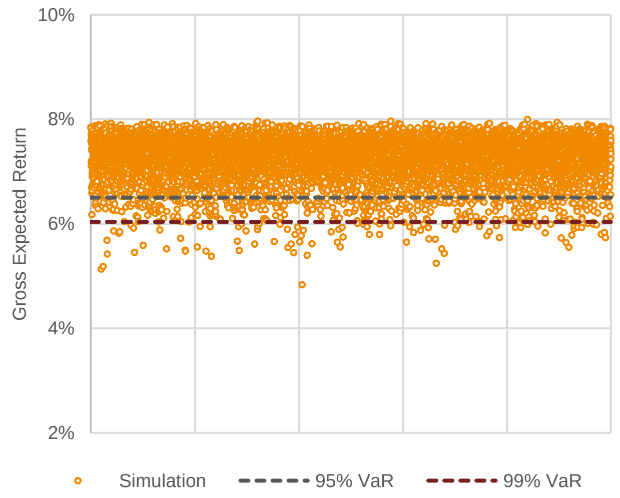
Overall, the changes in MDIF's underlying portfolio have not led to material changes in our simulations. The defensiveness of the portfolio has improved slightly due to minor risk reduction adjustments. The high level of counterparty diversification, along with the improved weighted average credit rating, has helped maintain our risk score of **Lower Medium** or "A".

Figure 17. Risk Score



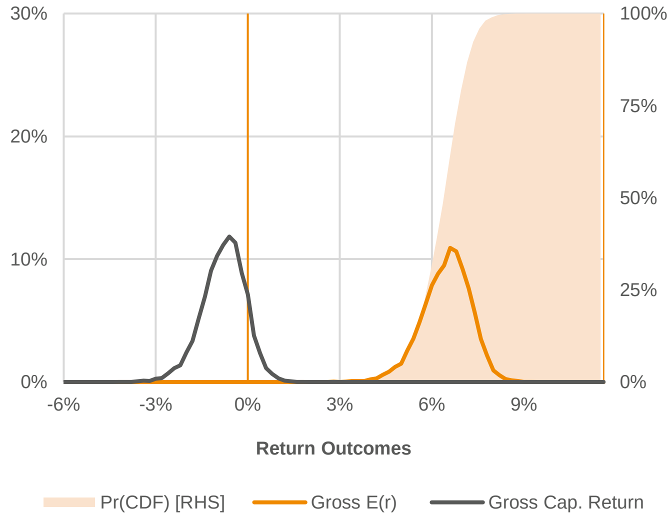
Scenario 1. Baseline Asset Assessment

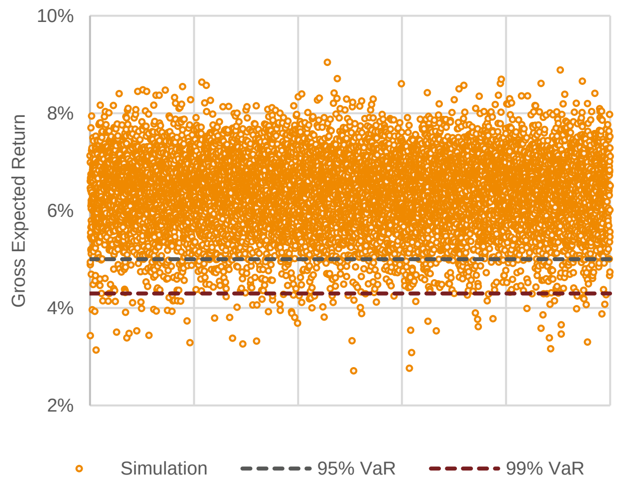




Source: BondAdviser Estimates as of 31 December 2023 portfolio. Excludes impact of management and origination fees. Gross capital returns excludes the value of coupons/income and is only modelling impairment or loss given default, based on historical credit data from Moody's. Impact of traded price is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

Scenario 2. Stressed Asset Assessment





Source: BondAdviser Estimates as of 31 December 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

Alternative Investment Fund Research Methodology

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