# Mason Stevens OCIO

## Private Credit Sector Review

## May 2023

This document is for dealer groups and wholesale or sophisticated clients only.

# Private Credit

# Sector Review

## Introduction

The Mason Stevens OCIO Private Credit sector review was completed in May 2023. This was a focused review of who we believe to be the best managers in market across Private Credit. This review has in turn informed decisions around managers on the Mason Stevens High Conviction List (HCL). This document details our thoughts on this asset class, the process and outcomes of the review, and summaries of each of the managers.

### What is Private Credit?

Private Credit broadly refers to debt financing provided by non-bank lenders to borrowers who typically either do not have access to bank financing or prefer not to use it. These loans are not publicly traded and are to varying degrees illiquid in nature.

Private Credit managers can be institutional investors, such as super funds and insurance companies, private equity firms, and alternative investment managers. These lenders may offer customised terms and structures that can be more flexible than those of traditional bank loans, including consideration around areas such as maturities, collateral, and covenants.

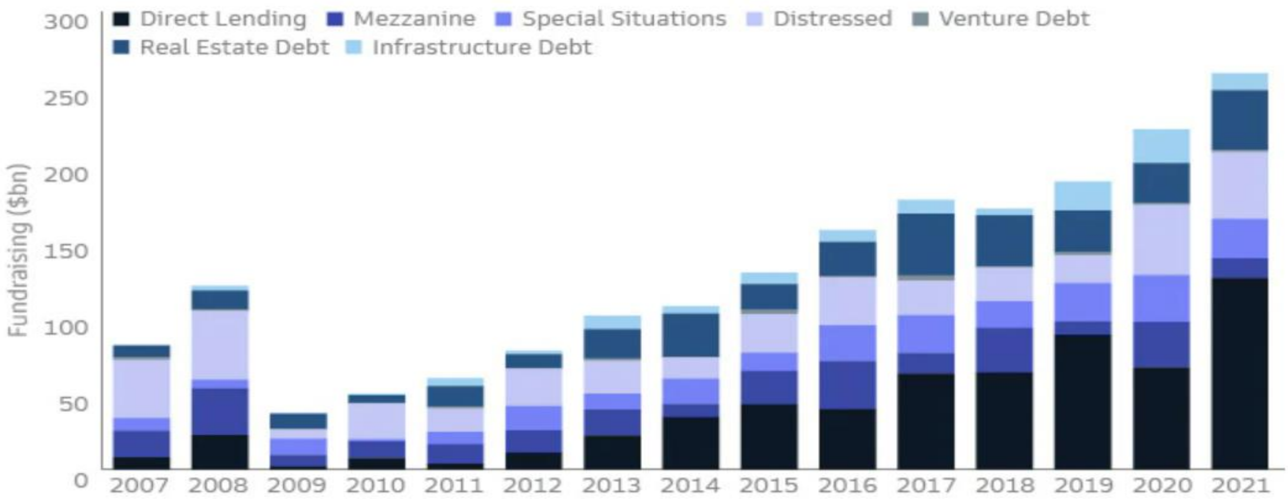
To provide some further definition in this space, see below for some broad sub-sectors.

- **Private Corporate Debt** – the private equivalent of publicly traded corporate bonds.
- **Private Residential Property Debt** – typically mortgage-backed securities purchased from non-bank lenders via warehouse structures.
- **Private Corporate Property Debt** – this takes the form of both direct commercial property and development lending, as well as commercial mortgage-backed securities.
- **Specialist finance** – typically asset backed securities that might be in areas such as insurance or motor vehicle finance.

# Sector commentary

Both locally and overseas we have seen significant growth in Private Credit in recent years as highlighted below.

### Chart 1: The Universe of Private Credit Strategies Has Been expanding, Diversifying




Source: Goldman Sachs

There have been two key drivers to this growth:

1. Banks increasingly stepping away from middle market lending. With enhanced capital requirements and risk weightings applied to certain assets banks hold on balance sheet, banks have increasing shied away from lending to SMEs. This has created demand from corporates for alternative sources of funding as they look to grow their businesses. As a result, Private Credit providers have looked to fill this void and been able to in large part drive attractive terms with their lending.
2. Ultra-low interest rates, which meant that up until 2022, there was a search for yield across markets. In this environment Private Credit funds targeting returns of cash +4% and higher have been seen to be very attractive.

## What are the potential benefits of an allocation to Private Credit?

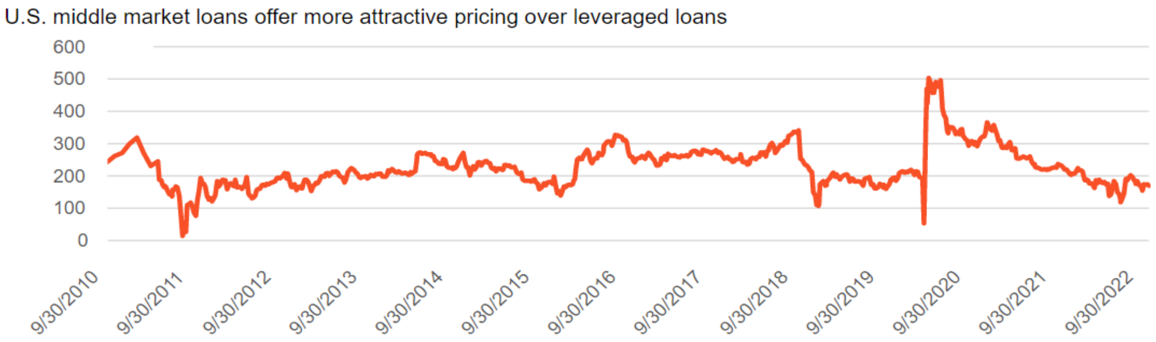
### Diversification within the defensive allocations of your portfolio

As outlined above, Private Credit typically operates where public markets do not. While there is some crossover, a Private Credit strategy will therefore give you exposures that you won't typically have in your traditional investment grade and high yield credit funds. In particular, from a local perspective, the access to middle market lending provides exposure to sectors that aren't as well represented at the top end of the resource and financials heavy Australian market.

### Higher target returns

Private Credit strategies should and typically do target higher returns than traditional credit funds. This should be expected given most strategies operate in the illiquid, sub-investment grade space and therefore need to offer these higher levels of compensation. This is underpinned by the fact that most corporates and debtors in this space can't get bank lending, and so are prepared to pay higher interest rates for their funding. See below for an illustration of the illiquidity premium in the US, where there is a deeper, more mature private credit market.

### Chart 2: Illiquidity premium




Source: Leveraged Commentary & Data September 2022

### Capital Structure and Controls

With Private Credit typically operating in the sub-investment grade space, managers will generally look to improve the risks of their investments by sitting up high in the capital structure of those entities that they lend to. The greatest security is typically attained by being senior secured, which places you ahead of other more subordinated debt and equity and is backed by an asset that is pledged as collateral. Long-term average recovery rates on senior secured lending in the event of a default are circa 80%.

The other way in which managers seek to improve their risk profile is through covenants that are arranged as part of the loan. Private lenders will often seek covenants around things such as a cash balances, earnings, and debt levels. If companies breach these covenants during the life of the loan, the manager will typically have access to a range of remedies such as a higher interest rates or future royalties from the company.

## Are there areas of concern?

The fact there has been a mini gold rush in Private Credit naturally means that it has attracted a broad spectrum of providers to the space. There are numerous managers that have been running for only a few years and have limited heritage as a private credit manager. That's not to say that a number of these newer providers can't ultimately be successful through time, however as of yet they haven't been tested through a cycle. What are the key things to consider in this case, when thinking about which managers to allocate to?

### Diversification

Either by design or because they are still in the early stages of FUM growth, many private credit strategies look particularly concentrated. This might be concentration in terms of holdings e.g. only having single digit or low double-digit number of portfolio holdings. It is also often sector concentrated, for example a strategy that just invests in the property sector.

As highlighted above there are approaches managers can take to minimise these risks in terms of being senior secured, strong covenants etc. However, it's important to understand that this only reduces a degree of risk. Many of these strategies are highly concentrated, and it requires an appropriate assessment of whether the returns on offer are commensurate with this risk.

### Liquidity

Private Credit is an illiquid investment class and the majority of holdings in most managers' portfolios are not investments that could be readily sold ahead of maturity. This is not a problem in and of itself but understanding this profile and ensuring a fund is structured accordingly in terms of any potential redemptions is important. A notionally more liquid offering may not actually be a positive because of the mismatch this creates in an environment where a weight of clients looks to liquidate holdings.

### Valuations and Volatility

Private Credit investments are by definition not publicly traded, and the valuations for portfolio holdings in any given fund is determined by the fund manager. Many managers in this space value their holdings at par unless there is an explicit impairment. Accordingly, you will often see a very steady and stable unit price for a given Private Credit fund. While this approach has a certain logic given these holdings are illiquid and there isn't explicit public market pricing, it also has the potential to create a false sense of security around the risks in a sub-investment grade portfolio, and an adverse reaction to a change in the unit price if and when a meaningful impairment occurs. Conversely, there are managers that are utilising a range of public and private reference points to mark to market the portfolio on a regular basis, providing in our view a better sense of portfolio valuation and conditioning clients to a degree of volatility. Wherever possible we believe this is a preferred approach.

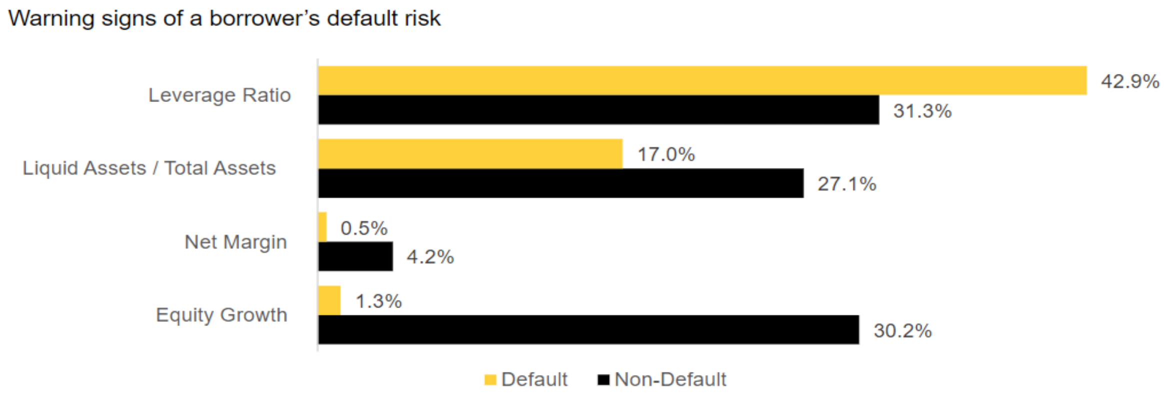
### Experience and Alignment

An additional and critical question to consider is the breadth and experience of the fund management team. Look to assess the degree of key person risk and whether the team have experience in this space through a full market cycle, and whether the team are well aligned to the end investors and relatedly how any fees are structured. We found there to be broad range of outcomes across the space.

### Credit Quality

Getting an understanding of the underlying leverage of the portfolio holdings in a fund will provide a further lens on how much risk is embedded in a given strategy. While a fund may typically have senior secured exposures, if these exposures are in highly leveraged micro and small cap companies, there remains a meaningful risk of default as highlighted below.

### Chart 3: Leverage and default




Source: Aladdi Private Issuer Database S&P CreditPro July 2022

Digging into the credit quality assessment a manager undertakes will provide a better sense of these underlying risks.

### Direct Origination or Syndication?

Private Credit investors, depending on the size and scale they operate at, can choose to either originate their own loans or alternatively invest with other creditors in a syndicate. Direct origination enables you to control the terms of the loan including any covenants and the ongoing relationship with the debtor. With syndicates, there is a lower level of control in terms of what the loan looks like, but it can open up unique opportunities that may not be available to you as a single creditor. Both approaches can in fact be complimentary in a portfolio, but understanding which risks you are taking with your manager and the payoffs involved are important.

# Scope of Review

There are approximately 30 Private Credit managed funds available in the local market, and this number is growing all the time. There are also 5 ETFs/LICs. Our review process seeks to identify the best in market managers across this broad universe.

## Initial Screen

In conducting a review of each asset class, the Mason Stevens process starts with a quantitative screen. Managers within each asset class and sub-asset class are reviewed in terms of performance and ratios within relevant peer groups. For Private Credit this is done as follows:

- Breakdown the asset class into smaller peer groups – global, domestic, diversified, sector specific
- Consider performance and alpha within peer groups over all timeframes but with a particular focus on 3, 5 and 7 years, which are timeframes that align to managers own stated objectives.
- Look at asset class relevant performance and risk statistics e.g. information ratio, sharpe ratio, income, correlations.
- ESG screen – use of Morningstar Sustainalytics to understand exposures and identify any poor performers in this space.
- Cost comparisons – look at total cost ratios in comparison with peers.

This screening process is designed to refine the list of managers under consideration to those where the data is strongly supportive of the manager having a level of investment skill in either alpha generation and/or risk minimisation. Morningstar Direct and Jacobi Analytics are the two main systems used for the quantitative screen.

## External Research House Screen

Mason Stevens will review external research house ratings for the asset class as well. This provides a qualitative check on the quant screen process, helping to identify managers for selection or de-selection that a quant screen in isolation may not. The major external research houses provide broad market coverage, detailed qualitative and operational research. Their output is a ratings methodology that clearly identifies their highly rated managers e.g. recommended and highly recommended. This effectively provides us with an expert second opinion, as well as a cross check against the quantitative screen.

Finally, we will on occasion review strategies that meet neither that quantitative or qualitative screening process, due to their newness in market, but where there is evidence of a compelling capability.

Through the quantitative and qualitative process outlined above, there were 20 strategies placed on a short list for detailed due diligence for the Private Credit review.

## Manager Due Diligence

Managers that passed both the quantitative and qualitative screen were engaged to complete a due diligence questionnaire (DDQ). This questionnaire is a detailed set of questions that covers key areas of consideration including more objective and data related areas as well as some open-ended questions. We also request key documents such as the Product Disclosure Statement (PDS)/Investment Memorandum (IM), investment recommendation samples, and the Financial Services Council (FSC) Questionnaire.

Review of this DDQ led to either proceeding with a meeting with the manager or being screened out. Manager meetings are always a multi meeting process with the aim to gain clarity in the following five areas:

- **Objective and philosophy** – What are they trying to achieve and what is the approach they are taking to achieve that? What is the manager’s underlying investment philosophy? What’s the evidence that this approach works and why do they think they have an information edge vs peers?
- **Organisation and people** – who is the fund manager, portfolio manager and analysts? How experienced are they? How stable has the team been? How well aligned are the team to the end objective of the fund?
- **Investment process** – is idea generation, security selection, portfolio construction and risk management coherent and does it tie back to the objective? We look for critical thinking and a clear view on what their competitive advantage is.
- **Fees** – are the fees competitive within the peer group and are any performance fees aligned to the interests of investors? Do they inhibit the stated objective?
- **Performance** – assessment of performance against objective and against peers, referencing back to quantitative screen process.

# Research Process

In going through this research process, the managers were scored against their peers using the following scale across the five areas mentioned previously of philosophy, people, process, price, and performance. The scoring outcome is defined in Table 1.

### Table 1: Mason Stevens Manager Selection Rating Process

| Individual Component Ratings | Explanation |
|---|---|
| 0 – 2.0 | Poor |
| 2.25 - 2.75 | Below average/below peers |
| 3.0 – 3.5 | Investment Grade/In line with peers |
| 3.75 - 4.25 | Recommended/ahead of peers |
| 4.5 - 5.0 | Highly Recommended/significantly ahead of peers |
| **Numerical Scores** | **Qualitative Score** |
| 0-2 | Sell |
| 2.25 – 2.75 | Below average/reduce |
| 3 – 3.5 | Investment Grade/Hold |
| 3.75 – 4.25 | Recommended/buy |
| 4.5 - 5.0 | Highly Recommended/buy |

Source: Mason Stevens OCIO

This scoring process provides a discipline in testing overall impressions, and potentially highlights where more work needs to be done before landing on a final score.

Further information on the Mason Stevens OCIO Managed Fund and ETF Selection Process can be found here.

## Review Outcomes

Our scoring noted above drives the outcomes, and typically the top two scoring managers in any given style are the managers added to the HCL. If an insufficient number of active managers meet at least the Recommended score, then that is when we may defer to a rules based or even market cap ETF to fill the style or sub asset class. The outcome from the review was to add the following managers to the Mason Stevens HCL as per Table 2.

### Table 2: Private Credit funds on the HCL

| Product Name | Style/ Segment | Available Structures | Fee discount available for Mason Stevens OCIO Clients? | Availability | Score |
|---|---|---|---|---|---|
| **Challenger Multi Sector Private Lending Fund** | Domestic | Fund | No | Wholesale | 4.25 |
| **Metrics Direct Income Fund** | Domestic | Fund/LIT | Yes | Retail | 4.25 |
| **Ares Diversified Credit Fund** | Global | Fund | No | Wholesale | 4.25 |
| **KKR Global Credit Opportunities** | Global | Fund | No | Retail | 4.25 |

Source: Mason Stevens OCIO

# Manager Performance

Below we have performance and volatility numbers for the private credit managers on the HCL. There are longer track records available for the below managers for different structures and versions of these same capabilities

### Table 3: Performance as at 30 June 2023 for Private Credit funds on the HCL with a local track record on the HCL

| Fund | 1 year (%) | 1 Year Volatility p.a. | 2 years p.a. (%) | 2 year volatility p.a. |
|---|---|---|---|---|
| Challenger IM Multi-Sector Private Lending Fund P | 9.10 | 1.72 | 6.74 | 1.76 |
| Ares Diversified Credit | 7.90 | 3.18 | 3.98 | 3.48 |
| Metrics Direct Income Fund | 7.93 | 0.35 | 6.23 | 0.57 |

Source: Morningstar

Past performance is not a reliable indicator of future performance.

### KKR Global Credit Opportunities Fund

This KKR Global Credit Opportunities Fund has only just been launched as a local trust. See below for the USD credit platform track record up to 31 Dec 2022.

| | KKR Credit Composite* Ranking vs High Yield Universe[1] | | | | | |
|---|---|---|---|---|---|---|
| Period | 1 Year | 3 Year | 5 Year | 7 Year | 10 year | Since Inception |
| KKR Credit Composite Gross Annualized Return* | -2.11% | 4.50% | 4.76% | 8.74% | 7.10% | 10.17% |
| KKR Credit Composite Net Annualized Return* | -2.64% | 3.91% | 3.87% | 7.46% | 5.75% | 8.54% |
| Quartile Ranking[2] | 2nd | 1st | 1st | 1st | 1st | -- |
| Percentile Ranking[2] | 34th | 15th | 9th | 3rd | 1st | -- |
| Rank / Total Managers | 85 / 246 | 35 / 245 | 22 / 234 | 8 / 221 | 2 / 192 | -- |

Source: KKR

# Manager Summaries

## Challenger Multi Sector Private Lending Fund

| | Challenger Multi Sector Private Lending Fund |
|---|---|
| **Summary** | A long standing wholesale client offering, that invests across a diversified portfolio of private corporate credit. |
| **Objective** | The Fund targets returns of the Bank Bill Index + 5% net of fees over the cycle. |
| **People** | Pete Robinson, the Head of Investment Strategy and the lead portfolio manager has over 19 years of experience and is supported by a team of 29 investment professionals. |
| **Processes** | » Detailed due diligence is the cornerstone of the process and involves traditional credit analysis (e.g., cash flow modelling) along with considerations on deal sourcing and structuring.<br>» The separate Credit Risk Team separately assesses and provides a recommendation with respect to a pure risk focus to the Investment Committee – this is a unique feature vs peers.<br>» A market leader when it comes to incorporation of ESG analysis into the private lending space – loans are regularly structured with ESG related covenants.<br>» Quarterly liquidity |
| **Fees** | 0.75% p.a. |

Source: Mason Stevens OCIO

## Metrics Direct Income Fund

| | Metrics Direct Income Fund |
|---|---|
| **Summary** | The strategy invests in a broad portfolio of domestic private debt and represents one of the most mature and diversified private credit manager available in the market |
| **Objective** | The Fund targets returns of RBA Cash Rate + 3.25% p.a. net of fees over the cycle |
| **People** | One of the best resourced private credit teams in the local market. Led by 4 highly experienced managing partners - Justin Hynes, Andrew Lockhart, Graham McNamara and Andrew Tremain |
| **Processes** | » The teams' deep experience in the sector as well as it's growing on the ground team, provide it with a strong pipeline of deals to review. Their focus is typically on deal size between $25-$75 million.<br>» Potential deals are screened based on a range or risk and return metrics, before more detailed due diligence work is done, including an important internal credit assessment focused on implied loss probabilities.<br>» The Investment Committee is responsible for all investment decisions and is comprised of the 4 Partners<br>» The fund has circa 300 loans diversified across sectors and a maximum of 5% with any one borrower<br>» Monthly liquidity |
| **Fees** | 0.68% p.a. |

Source: Mason Stevens OCIO

## Ares Diversified Credit Fund

| | Ares Diversified Credit Fund |
|---|---|
| **Summary** | A global, portfolio of predominantly directly originated loans managed by a leading Private Credit Manager. |
| **Objective** | The Fund targets high single digit returns through the economic cycle |
| **People** | Managed by two Portfolio Managers, Mitch Goldstein (with Ares since 2005) and Greg Margolies (with Ares since 2009). Supported by 390 investment professionals globally. |
| **Processes** | » A key competitive advantage is the integrated global platform supported by 180 direct origination professionals<br>» Focus on higher quality companies and sectors, avoiding industries with higher leverage and cyclicality.<br>» Ares looks to be the lead or majority holder of each loan it makes, seeking to control the terms of the loans.<br>» The fund is predominantly in North America, with a max of 30% in Europe. Ares generally try to keep approximately 20% of the portfolio in liquid securities (broadly syndicated loans, high yield bonds, and cash) so that any quarterly redemption requests can be met. |
| **Fees** | Management Fee of 1.25% p.a. Performance Fee of 15%, subject to an annualised hurdle rate of 6%, with a catch-up provision |

Source: Mason Stevens OCIO

## KKR Global Credit Opportunities

| | KKR Global Credit Opportunities |
|---|---|
| **Summary** | A diversified global portfolio of both High Yield and Private Credit, typically split 50/50 between the two sectors |
| **Objective** | Outperform the 50% BAML HY Index / 50% S&P LSTA Loan Index (AUD Hedged) by 2-3% p.a. over the cycle |
| **People** | This capability has a heritage back to 2008 and importantly 3 of the 4 PMs have been managing the strategy since inception - Chris Sheldon, John Reed and Jeremiah Lane. Supported by a team of 39 analysts globally |
| **Processes** | » Investment selection process predominantly relies on bottom-up, security-based credit analysis, with a focus on downside risks. Analysts are responsible for recommending the best risk-adjusted return opportunities<br>» Avoid businesses that do not generate free cash flow over the investment horizon; have meaningfully unhedged commodity risk; or have unsustainable capital<br>» The portfolio is then constructed as a best ideas portfolio with exposure to 150-250 securities from a research coverage of approximately 1600<br>» Monthly liquidity |
| **Fees** | 0.82% p.a. |

Source: Mason Stevens OCIO