The Inside Network

INVESTOR ACADEMY

Credit Masterclass

Summary Report

21 April 2021
Collins Square, Melbourne

Understanding the growing opportunity in credit markets

Credit Masterclass 2021

INTRODUCTION

The role of fixed income in traditional strategic asset allocation portfolios was threefold; deliver an income, protect real capital and reduce volatility. Thirty years of falling interest rates, quantitative easing, and now yield curve control has seen fixed income assets deliver exceptional returns. As it stands today, however, all three roles of traditional fixed income assets are coming into question, with yields close to zero and the threat of capital losses, should interest rates rise in the years to come. In an environment of near zero interest rates, institutional investors and financial advisers alike are turning to alternative credit.

Private debt, at its most simple, is defined as the provision of credit or loans to companies, individuals or other entities; effectively acting as the lender. A confluence of events over the last decade, but primarily changes in the risk weightings, banks apply to non-residential property backed debt, has seen a significant constraint in the supply of debt to businesses across Australia. This looks set to change opening up a channel for investors.

The retreat of the Big Four Banks offers products with a rare combination of higher income, secured by a range of different assets, and diversified across multiple industries. The growing opportunity set has seen a flood of operators enter the market, or open institutional products to the broader market.

Not all credit strategies are created equal or aim to address similar segments. As with any asset class, credit requires a detailed understanding to assess its appropriateness for any investor. In this session, our experts will cover the most importance aspects to understanding the opportunity in credit, touching on the following issues across six modules:

DURING THE MASTERCLASS WE COVERED EVERY ASPECT OF CREDIT INCLUDING:

1. The role and outlook for credit
2. Income diversification through private credit
3. Evolution of the real estate credit sector
4. Loan Structuring: Art or Science?
5. Fitting credit into portfolios

Education Partners

JANA

JANA is a majority management-owned, independent asset consultancy, that uses its structure, processes, tools and diverse group of industry professionals to help clients unlock opportunities. JANA's consultants hold dual research and client consulting roles, ensuring that those undertaking the research have a deep understanding of how it's delivered and applied.

CIP ASSET MANAGEMENT

CIP Asset Management originates and manages assets for leading global and Australian institutions. Our clients benefit from the teams' experience, scale and unique offerings. CIPAM includes three businesses: Fixed Income, Real Estate and Solutions.

ALCEON

Alceon Group is a privately owned financier and multistrategy alternative investment manager. Established in 2010 and headquartered in Sydney, Alceon has invested over $3.8 billion of capital for its high net worth, family office and institutional clients across real estate, private equity and listed equity.

METRICS

Metrics is a leading Australian nonbank corporate lender and alternative asset manager specialising in fixed income, private credit, equity and capital markets. Through their managed funds they provide unrivalled access to the highly attractive Australian private debt market to investors ranging from individuals to global institutions.

EPSILON DIRECT LENDING

Epsilon is Australian based non-bank lender and private markets investment manager specialising in providing bespoke financing to high quality, credit-worthy Australian middle market companies. Epsilon aims to provide flexible and creative financing solutions to middle market companies, while delivering attractive, stable returns for investors, in all cases operating with the highest levels of integrity, reliability, and transparency.

A snapshot


Why hold credit in portfolios ?
provides stable income
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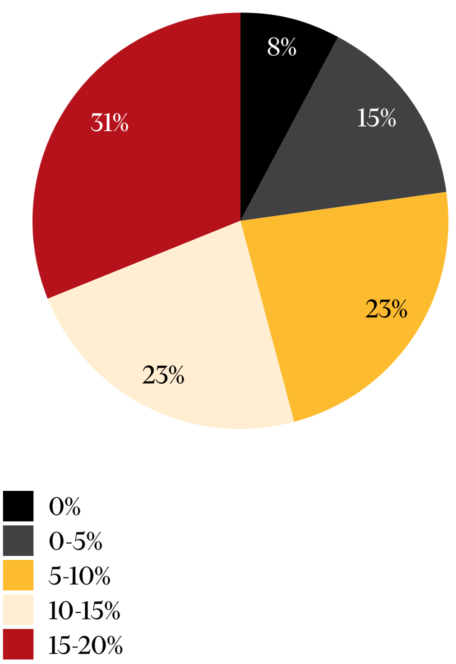
Types of Private Debt
Corporate
Leveraged & Acquisition

Module 1:

The Future of Fixed Income

IN YOUR PORTFOLIO, WHAT IS THE CURRENT ALLOCATION TO CREDIT - PRIVATE OR PUBLIC?



The first module was presented by Michael Karagianis, of JANA Investment Advisers.

Michael was tasked with delivering a detailed update on evolution of the credit sector and its growing role within diversified, modern investment portfolios. Michael offered an in-depth review of the credit sector in 2020 and the powerful global trends have seen the asset become increasingly common for both institutional and wholesale investors.

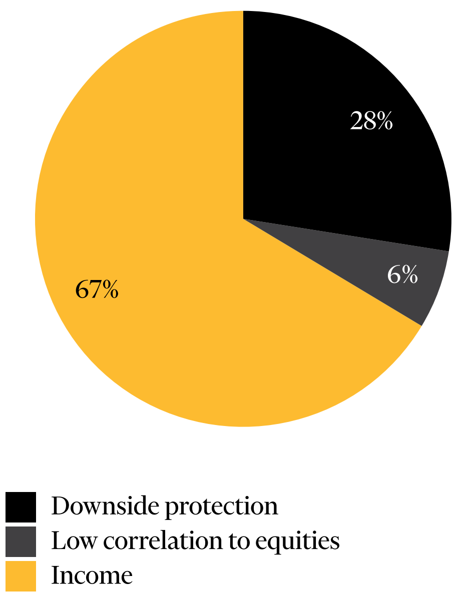
THE MAJOR TAKEAWAYS FROM THE SESSION INCLUDED:

1. Credit is an important, but less conventional, part of the 'fixed income' asset class;
2. Traditionally considered a 'defensive' asset, credit is by no means homogenous;
3. Fixed income ranges from high quality / low risk government bonds, to low quality / high risk, with plenty in between;
4. Correlation with other risk assets like equities tends to increase as you move down the capital structure;
5. Pandemic has contributed to the collapse in rates, with depressed future return expectations;
6. Credit spreads on most sub-asset classes are already back to pre-COVID levels;
7. 68% of the bond universe now yields 1% or less, with 26% remaining negative;
8. Credit outlook is closely tied to central bank actions, US treasury yield and economic conditions;
9. Jana has a 'neutral' view on credit compared to a 'very unattractive' view on traditional fixed income;
10. Credit is considered less overvalued than some asset classes, offering yield enhancement;
11. Cautioned against focusing on domestic options, with rating and quality diversification only available in global markets;
12. Warned that private credit passes due diligence risk onto the investor/manager.

Module 2:

Senior, secured, subordinated, convertible – income diversification through private credit

WHAT FACTOR ARE YOU MOST AIMING TO CAPTURE IN PRIVATE DEBT?



The second module was presented by Graham McNamara of Metrics Credit Partners.

Metric's is one of Australia's leading fixed income and private credit specialists, having grown to $5 billion under management since their founding in 2013. The group offers loans to Australian corporate borrowers of all sizes and across all industries, tailoring each deal to their specific needs. Graham offered a deep dive analysis into the structure and sub sectors within the credit asset class and the differing risk-reward profile of each.

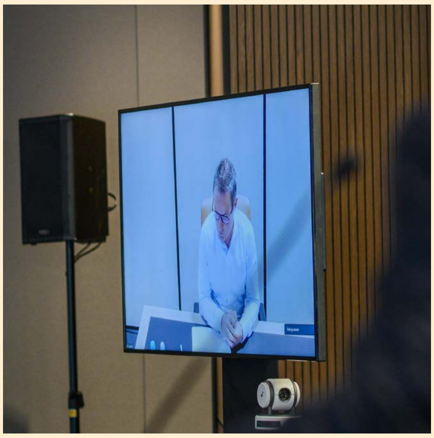
THE MAJOR TAKEAWAYS FROM THE SESSION INCLUDED:

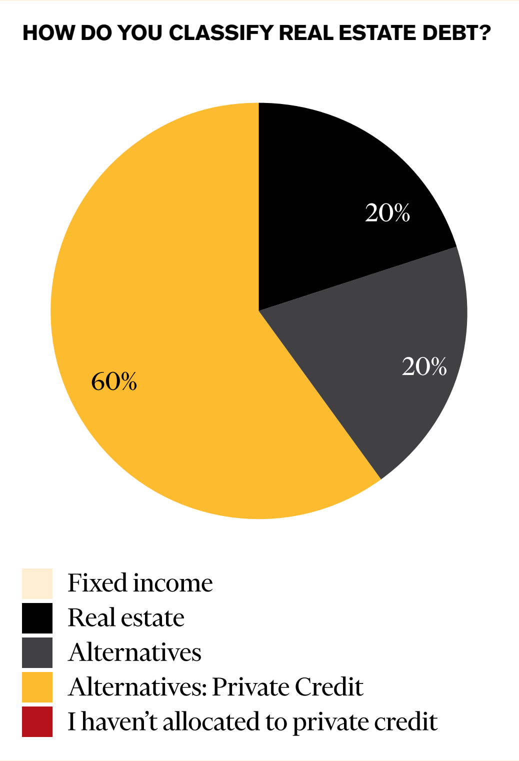
1. Consistent income and capital stability are all but gone from traditional assets;
2. Private debt offers a range of return objectives, from 4-5% for low-risk, to 10-12% for high yield strategies;
3. Being predominantly floating rate loans, private debt offers protection from inflation;
4. Whilst equity values of corporates are volatile, debt values are static and contracted;
5. Private markets afford more flexible loan structures and greater security;
6. Lenders are able to access 'private side' information not available to the market to assess loans;
7. Australia's strong insolvency regime ensures debt holders are able to seize control;
8. Private credit offers access to sector diversification outside State Government and financial sector;
9. Diverse opportunity set includes:
    - Direct lending to large corporates – BBSY + 1.25% to 2.50%;
    - Direct lending to mid-market corporates – BBSY + 2.00% to 4.50%
    - Leveraged Loans & Acquisitions – BBSY + 5.50% to 6.50%;
    - Commercial Real Estate – BBSY + 1.75% to 5.00%;
    - Development Loans – BBSY + 5.00% to 16.00%;
    - Infrastructure Lending – BBSY 1.75% to 3.50%;
    - Subordinated and Mezzanine options;
10. Becoming the bank allows investors to capture upfront fees, base rates, interest margins and facility fees in their profit margin;
11. Loans to larger ASX-listed corporates tend to be unsecured rather than secured;
12. Private debt tends to come with greater security, access to information and ability to exert influence;

Graham finished the session by walking attendees through the case study covering Ramsay Healthcare's (ASX:RHC) pandemic capital raising. He highlighted the company seeking to work with lenders to loosen the terms of their covenants, in return for undertaking a large equity raising to de-risk their balance sheet.

Module 3:

Evolution and Growth of Real Estate Debt





The third module was presented by Damien Cronin and Omar Khan of Alceon and Freehold Investment Management.

These two businesses, one a diversified alternative investment manager with decades of experiencing financing a wide variety of projects and assets and the second a real estate and investment specialist, recently merged to become a $2.5 billion manager. This session was dedicated to understanding the evolution of lending in the real estate sector, with a particular focus on the opportunity set emerging as the major banks continue to retreat.

THE MAJOR TAKEAWAYS FROM THE SESSION INCLUDED:

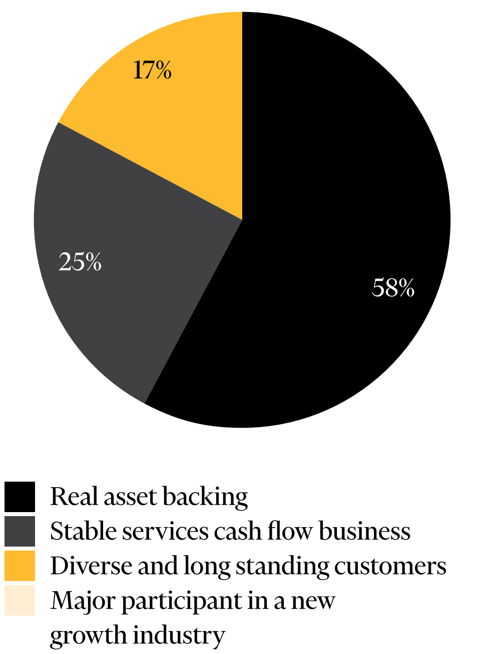
1. Real estate debt extends beyond construction and acquisitions and the opportunity set continues to grow;
2. The universe includes Land Finance, Residual (leftover) Stock, Construction and Commercial Property backed loans;
3. Capital restraints on bank lending will continue to be the main driver of growth in non-bank lending market share;
4. Australia's full recourse lending framework makes the sector 'lender friendly' compared to global counterparts;
5. Property developers are being forced to raise larger amounts of equity as banks seek to de-risk their loans;
6. Mid-market sector offers the greatest opportunity, with less price competition than the larger ($100m+) borrowers;
7. Returns remain strong, 10-12% for construction finance, but competition is sending these lower;
8. Investors should be seeking c7 – 12% on first mortgage, secured construction debt;
9. Every type of loan, be it Land Finance, Construction or Residual, requires a unique approach to due diligence;
10. Investors tend to treat real estate debt as a combination of fixed income and property exposure;
11. Even in the worst case, a fall in property values and presale defaults, senior lenders will remain protected;

Damien and Omar finished by taking delegates of a case study of a unique lending opportunity in Canberra. The project was the development of 68 apartments plus commercial sites, which the major banks required significantly higher presales to even consider lending against. The time taken to deliver said presales would significantly reduce the return for the developer, so they sought more flexible, higher cost finance and successfully delivered on the project.

Module 4:

Due Diligence/Loan Structuring: Art or Science?

WHAT WOULD YOU CONSIDER THE LOWEST RISK FORM OF LENDING?



The fourth module was presented by Mick Wright-Smith and Joe Millward, Epsilon Direct Lending.

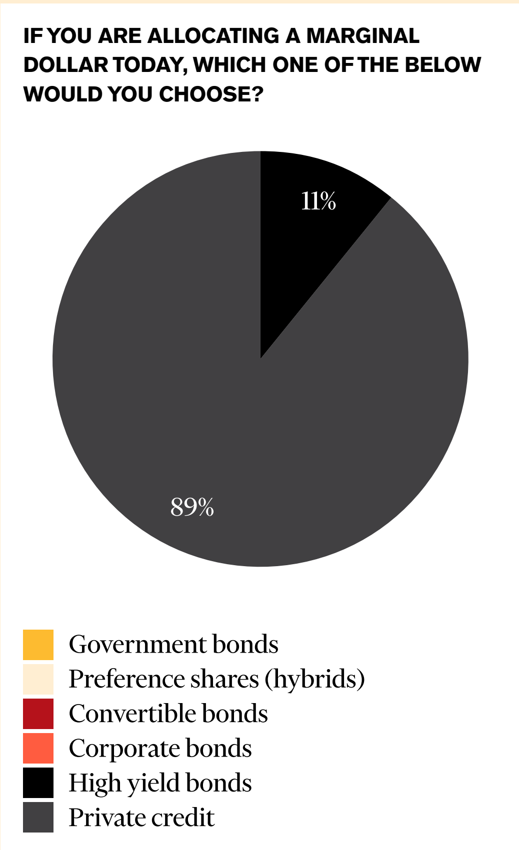
Joe and Mick, alongside their co-founder Paul Nagy, recently left the Commonwealth Bank's Corporate Finance team to establish Epsilon, a private lender focused on mid-market, growing companies. The session was dedicated to understanding the key risks of corporate lending and the most important due diligence considerations for each type of project or opportunity.

THE MAJOR TAKEAWAYS FROM THE SESSION INCLUDED:

1. Loan structuring is the most important part of the process, particularly in private markets;
2. Investors must focus on Quantum, Tenor, Controls and Return from each deal;
3. Cash flow or lending secured by a company not property, has proven to be as secured as the latter over the long-term;
4. Lending to larger companies is solely about the interest rate on offer, the risk is accepted;
5. Returns and interest rates should be the last consideration in private market lending, with serviceability a key focus;
6. Deal assessments can extended from six weeks to as long as 18 months;
7. Quality lenders can miss as many as eight of every 10 ideas due to their extensive due diligence process;
8. Real world experience is integral in identifying borrower red flags before they become an issue;
9. Workouts aren't always negative, but require skill to act and manage appropriately;
10. Private market due diligence is more detailed due to access to non-public, private side information;
11. Lender transparency into business operations is higher as the size of the company reduces;
12. Sustainable, predictable cash flow is the most important determinant of success in private lending.

Module 5:

Fitting Credit into Portfolios



The final module was presented by Pete Robinson, of CIP Asset Management.

CIP AM is part of the Challenger Financial Group's asset management arm, having supported the investment of the group's annuity book since 1998. The group has recently expanded its retail and wholesale offering with Pete Robinson the head of Investment Strategy for the Fixed Income Team. Pete's session covered the entirety of the credit sector, offering insights into how delegates can build a diversified credit portfolio including both public and private market instruments.

THE MAJOR TAKEAWAYS FROM THE SESSION INCLUDED:

1. The credit market is split into three sub classes:
   - Cash-like – short-dated, investment grade, floating rate;
   - Rates-like – long-dated, investment grade, fixed rate;
   - Equity-like – short-dated, sub investment grade, floating rate;
2. The illiquidity premium remains the most significant benefit of the asset class;
3. Credit allows investors to reduce their reliance on duration and credit risk for returns;
4. Market duration, or time to maturity, has extended at the same time yields have compressed;
5. Credit's correlation with equity markets is not consistent, it varies widely over time, requiring active management;
6. The case for investment grade credit is limited, as interest rates and return potential reduces;
7. High yield credit can replace equity allocations without significantly impacting on CPI + objectives;
8. A portion of excess return from credit markets comes from the disintermediation of the banking sector 'intermediaries'
9. Illiquidity is an asset class of itself and should be considered as such in portfolio construction;
10. Overtime the average illiquidity premium in private credit has been 2.2% per annum;
11. Private credit allocations can enhance risk adjusted returns (Sharpe ratio) in both high and low rate environments;
12. Floating rate nature of credit reduces portfolio exposure to the sensitivity of interest rate moves.

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