360 Capital Credit Income Fund

May 2020

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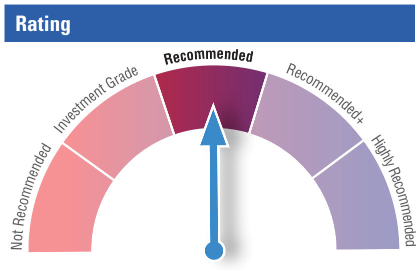
360 Capital Credit Income Fund

Note: This report is based on information provided by the company as at May 2020

Rating



Key Investment Information	
Name of Fund	360 Capital Credit Income Credit Fund
Investment Manager	360 Capital Credit Management Pty Limited
Responsible Entity	360 Capital FM Limited
Investment Type	Managed Investment Scheme
Fund Term	Open-ended Trust
Inception Date	13 May 2020
Initial Offer	13 May to 13 Sep 2020
Unit Issue Price	$2.00
Min Investment	$2,000
Target Total Returns	RBA Cash + 4%
Valuation Frequency	Monthly
Redemptions	Hard lock-up until May 2023. Six monthly thereafter
Redemption Notice	One month prior to Redemption Event
Distribution Policy	Monthly
MER	0.85% p.a. of GAV
Performance Fee	Based on ERS returns only. No Performance Fee (PF) < 8% p.a Fund Total Return (TR). 2% PF for Fund TR 8-10% p.a. 20% PF for Fund TR in >10%

Fees Commentary

The fee structure is well structured in IIR's view. The performance fee is only applicable to the ERS strategy. With a target portfolio weight of 5% the realised performance fee is expected to be minimal. Further, it is consistent with the stated risk and return profile, providing no incentive to creep to a higher than stated risk profile.

Target Portfolio Characteristics	
Loan Segment	Low to Mid-market Corporate
Loan Type	Senior Secured, Subordinate / Mezzanine, Special Situations
Underlying Loan Sizes	$5m - $30m
Tenures	3 - 5 years
Leverage	Up to 30% of GAV

The investment opinion in this report is current as at the date of publication. Investors and advisers should be aware that over time the circumstances of the issuer and/or product may change which may affect our investment opinion.

OVERVIEW

The 360 Capital Credit Income Fund ("the Fund") is a newly established fund that provides investors exposure to the Australian lower-mid market private debt market (target loan size of $5m-$30m). The Fund will be managed by 360 Capital Credit Management Pty Limited ("the Manager") which is wholly owned by the 360 Capital Group. The Fund will target direct lending to Australian and New Zealand mid-market corporate borrowers. Portfolio of loans will be diversified across borrower, industry, maturity and geography with transparency over the loan portfolio. The Fund intends to access the corporate loan market through the following loan strategies: 1) Senior Secured Loans; 2) Subordinated and Mezzanine Loans; and 3) Enhanced Return Strategies (ERS) (special situations). The longer term portfolio split between these three loan strategies is expected to gravitate around the following allocations: 85% senior secured; 10% mezzanine; 5% enhanced return. The heavy weighting to senior secured loans reflects a strategic emphasis on lower credit risk, rather than stretching for yield, as well as a focus on preserving investor capital. The Manager has a very proactive approach to structuring and managing its credits. It facilitates this by being either the sole-lender or, in the case of syndicated corporate loans, being the lead or co-lead lender. This provides for greater transparency and deal control, with the potential to structure more favourable pricing, collateral, covenants, and other credit terms, in addition to greater control / influence in the event of a default and potential recovery / workout situation. The Fund is targeting return of at least RBA Cash plus 4.0% p.a. (currently 4.25% p.a.) paid monthly. Distributions will be paid monthly commencing June 2020 with a Guaranteed Return until 13 May 2021 of 2.50% p.a (net of fees and costs) to those investors who subscribe during the Initial Offer. The Fund will be subject to a liquidity hard lock-up of 36 months post the offer open date (being 13 May 2023). Thereafter, unitholders will have the opportunity to redeem at the end of each subsequent six month period (in November and May).

INVESTOR SUITABILITY

The Fund is designed to deliver stable returns with exposure diversified across credit market segments, borrowers, industries and origination channels and lower risk of capital loss created by the defensive nature of primarily senior secured credit investments. IIR deems the investment strategy to be at the lower end of the risk spectrum of private debt based on predominantly first lien security, prudent underwriting, a very proactive approach to portfolio monitoring, which includes the investment team's significant experience in resolving deteriorating credits, and an average borrower credit rating profile B and BB (sub investment grade). IIR has for some time viewed the lower mid corporate lending segment as providing arguably close to the most attractive risk-return profile in all developed world private debt markets. It does so by partly through a persistent illiquidity and complexity premium, attractive arrangement fees, being a less competitive lending segment, having superior lending protections, and debt typically being extended direct bi-lateral basis. The latter of which provides greater 'ball control' and transparency for a lender in which to mitigate downside risks in any given loan. Further, in Australia in a post COVID-19 environment the opportunity set for non-bank lenders in the target segment is not only very significant but increasing. Additionally, borrowing rates have increased by circa 200 basis points for a given level of risk (although risk is difficult to truly judge currently) versus pre COVID-19. On a relative basis, yield seeking investors should also keep in mind that the income (plus capital) risk in equities is significant currently.

RECOMMENDATION

IIR ascribes a "**RECOMMENDED**" rating to the 360 Capital Credit Income Fund. The investment strategy is managed by an experienced team in the corporate lending segment. While the Fund is newly formed, IIR has a high degree of conviction in the Manager's ability to achieve the stated total returns objective over the foreseeable future given the strength of the investment process and broader resources at the 360 Capital Group.

SWOT ANALYSIS

Strengths

- The investment team, while newly formed within the 360 Capital Group, have significant experience in the lower to mid market lending segment targeted by the Fund. The three member team is led by Chris Chase (Head of Credit). To date, Chris has been involved in the underwriting, management and repayment/realisation of around $3bn in transactions. The Manager applies an 'equity mindset' to credit exposures which helps the early identification of risk and proactive engagement with the borrower to protect underlying security and ensure a clear exit strategy.
- The advantage of being a newly established fund in a post COVID-19 world is partly four-fold in IIR's view: 1) existing portfolios have not been potentially compromised in terms of interest payment and default risk by the unprecedented and unforeseeable events of the virus and in which previously very solid lends may now have increased significantly in terms of risk profile (valuation risk); and, 2) there will potentially be a marked increase in secondary market opportunities as existing lenders may be subject to liquidity, workload, valuation, and portfolio rebalancing issues; 3) existing borrowers may be in need of additional capital (over and above an existing debt facility from a third-partly lender), presenting mezzanine lending opportunities to cherry picked solid business and, being a mezzanine facility, at potentially materially higher interest rates; and, 4) the opportunity to set an entire portfolio at the elevated level of returns in the current environment (up circa 200 bps) versus pre-COVID-19, noting that many of the funds raised in the midst of the GFC in 2008 generated outsized returns.
- IIR expects the lower mid-market (loan sizes just below $50 million) the Fund targets will continue to perform well. These corporate borrowers are large enough to have sufficiently strong underlying characteristics to be a safe credit risk, and have credit ratings on a par with or perhaps better than those at the higher end of the mid-market due to lower leverage levels. The segment has not been subject to the covenant deterioration (cov-lite, EBITDA addbacks, etc) and aggressive leverage levels that has characterised the large company private debt market. Further, the lower mid-market has less competition than the larger corporate lending segment Lenders in this space are also able to manage loans actively by requiring board observer seats, monthly and quarterly financial statements, quarterly compliance certificates and annual independent audits. Superior visibility into borrower performance coupled with control of the loan voting rights allows the lender to exercise its rights early on in order to firmly address problems before they result in payment defaults or loss of principal. Many of these characteristics have been unavailable in the larger loan market.
- The fee structure is well structured in IIR's view. The performance fee is only applicable to the ERS strategy. With a target portfolio weight of 5% the realised performance fee is expected to be minimal. Further, it is consistent with the stated risk and return profile, providing no incentive to creep to a higher than stated risk profile. "Show me the incentive and I'll show you the outcome", in the words of Charlie Munger. Given the origination and management of the loan book is very much based on a 'high touch' approach by the Manager, which investors ultimately benefit from, we believe the Fund is very competitively priced.
- The open ended structure is designed by substantially mitigate the cash dilution risk inherent in the close-ended structure and, more importantly, the requirement to quickly invest large sums of money raised through an IPO or secondary capital raise, the latter of which can lead to a deterioration in prudential lending standards.

Weakness

- While IIR has conviction in the Manager's ability to achieve the targeted income objective of the Fund, we note the Fund is newly formed and therefore lacks the benefit of a proven track record. Further, while there is substantial lending experience within 360 Capital Group, mitigating any potential key person risk issues, we note the team is small and the investment team members relatively new to the 360 Capital Group (i.e., team stability has yet to be proven).
- The non-bank private debt market in Australia, while growing quickly, remains relatively small and, as per other private debt geographic markets, does not have the historical data visibility of traded debt markets. Most critical in this regard is historical default and recovery rates and a sectoral breakdown of these metrics. That said, the broad consensus is defaults have historically peaked somewhere in the range of 1%-3%. This

is substantially lower than public debt markets (both HY bonds and leveraged loans) where protections and 'ball control' can be substantially lower.

- While recognising that private debt managers are generally hold to maturity investors in respect to each loan, in periods of market dislocation managers may be forced into secondary market sales of a component of a loan book, and possible to funding redemptions. This increases the importance on up-to-date valuations as well shifting the existing weights of various valuation methodologies to be based more on recent market transaction values. There are no hard and fast rules about valuation which, as has become evident with some industry based Super funds, reduces transparency and confidence in addition to wealth transfer issues with respect to remaining investors created by redeeming investors . Furthermore, IIR's understanding is private debt managers generally do not factor in a collective default provision, as banks are required by regulation (generally 1-3%), thereby arguably overvaluing a loan book.
- The Fund is subject to a liquidity hard lock-up of 36 months (being 13 May 2023) and thereafter a redemption facility will be offered every six months. A hard lock-up period is necessary for the strategy and the 3 year period to some degree matches the general loan tenor (3-5 years). Nevertheless, its a long lock-up and IIR questions whether there could be a less restrictive structure based on service redemption requests based on inflows (the degree to which would be at the discretion of the RE). Investors must adopt a 3 to 5 year investment horizon for the Fund.

Opportunities

- Given the market dislocation event, the reassessment of risk premia, and the compression of interest rates between bank and non-bank lenders (as banks seek to retain margin as the RBA Cash Rate has declined), there has been a material increase in market interest rates. In this environment, the Manager believes that many credits it will look at will be priced at between 7%-9% for a loan book that will predominantly be BB and B credit quality, with a smattering of BBB. In effect, investors will benefit from a sub-investment grade return on an investment grade loan book.
- Changes to regulatory and prudential regimes has seen traditional banks tighten lending requirements and in some cases, reduce or withdraw offering credit particularly to mid-market corporates. This has created significant demand with non-bank sourced funding now overtaking traditional bank sourced funding for mid-market corporates. The Fund offers individual investors direct access to private credit opportunities traditionally accessible primarily by institutional investors.
- Private debt offers several advantages over the traded sub-investment grade markets of high yield bonds and bank loans (public debt). These include more detailed due diligence information, senior investments benefiting from security over assets, lower marked to market volatility and higher returns. For these reasons, IIR views private debt strategies such as pursued by the Fund as a sensible allocation within a larger holding of debt related investments.
- With interest rates at historic lows in Australia (and likely to remain so for the foreseeable future), demand has and will continue to grow for higher yielding investments. In IIR's view, there is a marked disparity between income and capital risk in equities versus private debt currently, with the former already showing considerable dividend deterioration not too mention capital risk given an equity investment in a company is first loss. Further, given record low cash interest rates, the Fund may represent an attractive option to investors seeking to reallocate a component of their holdings out of cash.
- Given the largely first lien senior secured nature of the direct loans the Fund will engage in, IIR considers the targeted yield premium to that generally derived in the more established North American and European private debt markets, let alone to the liquid / bank loans market, as attractive to very attractive on a risk-adjusted basis.

Threats

- Loan impairments may adversely impact total returns to investors. We note the Manager has a strong track-record across a full market cycle and in insolvency, restructuring, and workouts in addition to create a portfolio reflecting COVID-19 resilient borrowers. Nevertheless, risks will persist given uncertainties about the duration, depth, and the complexity of the 'supply-chain' of disruptive forces that every business will be subject to. No investment market commentator has transparency on these forces. While GFC lending experience is highly valuable, the GFC was a liquidity event whereas the COVID-19 crisis is a cashflow/solvency event.

- Prior to COVID-19, the general perception was that over time, as a greater degree of capital flows into the non-ADI private lending segment and the market became more efficient, the risk was the market would likely to contract in terms of yields. One manager IIR reviewed estimated that the order of magnitude of yield compression could be as much as 200 basis points over the next two years, or so, for any given risk profile. Clearly, the situation has completely reversed. Nevertheless, over the longer term the risk is likely to re-emerge.
- As a general comment, in a post COVID-19 world, fund managers of newly / less established that are in the early stages of a fund raising process may face challenges gaining the attention of prospective investors. To prepare for the uncertainties ahead, fund managers in the process of fundraising should be prepared and consider extending the fundraising period to assist in achieving adequate investment scale and portfolio diversification.

PRODUCT OVERVIEW

The Fund's investment strategy aims to exploit market inefficiencies (and an associated funding gap) driven by increased capital adequacy requirements on traditional bank lenders and increasing risk and compliance costs. In addition to this dynamic, there is an increase in borrower demand for alternative sources of debt capital. Over the immediate term, this is likely to only increase due to 1) the interest differential between bank and non-bank lenders has declined and 2) banks have a severe workload due to COVID-19 regulated and market demands, primarily in the SME lending segments, such that the lower mid-market borrowers are being under serviced.

The Fund will execute its strategy by originating lower to middle market corporate loan transactions primarily through direct and advisory channels across Australia and, to a far lesser degree, New Zealand. Borrowers are generally classified as those that have earnings (EBITDA or its equivalent) of a minimum of $5M up to $50M, and revenues of $50M up to $500M. On a selective basis the Fund may provide facilities to groups outside of the above parameters, namely independent credit platforms, however the Fund will not actively originate transactions in these markets.

The Fund's core principles in credit selection will focus on borrowers that can demonstrate a robust business model with strategic and operational differentiators, sustainable cash flow, proven and experienced management teams and well understood and defined secondary markets. In short, borrowers and businesses that are viewed as being COVID-19 resilient. This selective focus on the above criteria has clearly become even more important in a post COVID-19 environment.

The Fund intends to implement its corporate lending strategy through three lending sub-strategies: 1) Senior Secured Loans; 2) Subordinated and Mezzanine Loans; and 3) Enhanced Return Strategies (ERS). The longer term portfolio split between these three loan strategies is expected to gravitate around the following allocations: 85% senior secured; 10% subordinated and mezzanine; and 5% enhanced return. The heavy weighting to senior secured loans reflects a strategic emphasis on lower credit risk, rather than stretching for yield, as well as a focus on preserving investor capital.

Corporate lending will be generally secured by cash flows in addition to property where deemed appropriate. The debt capital may be used for general business requirements, growth capital, acquisition finance, transformational capital, and potentially bridging finance.

The Manager has a very proactive approach to structuring and managing its credits. It facilitates this by being either the sole-lender or, in the case of club corporate loans, being a co-lead lender. This provides for greater transparency and deal control, with the potential to structure more favourable pricing, collateral, covenants, and other credit terms, in addition to greater control / influence in the event of a default and potential recovery / workout situation.

The investment team consists of three dedicated members, with the leadership team with more than 20 years' operating experienced in funds management, banking and risk management. The Fund is headed up by Chris Chase (PM) who brings more than 14 years' experience in originating and executing transactions in the mid-market lending space, in addition to borrowers funding corporate M&A and business expansion. Prior to joining the 360 Capital Group, Chris spent time at Macquarie Bank, CBA and ANZ within their Corporate Finance, Corporate Banking and Institutional businesses. Mitchell Peasley complements Chris well, having substantial insolvency, restructuring and workout risk. Additionally, there is also

substantial directly relevant lending experience in the Credit Committee (CC), particularly Tony McGrath (founder of McGrathNichol) and Andrew Moffat (corporate and investment banking experience).

The Fund is initially seek to raise $150m-$200m, which should enable adequate diversification. Given the open-ended structure of the Fund, the Manager will seeking to progressively increase the scale of FUM over time, and thereby permitting a greater degree of diversification by borrower, industry, and loan type strategy. Initially, the portfolio is expected to be substantially, and possibly wholly weighted to the Senior Secured Strategy. This is a sensible risk mitigation strategy. As the Manager notes, in the initial period given lower FUM, a loan impairment would possibly be more detrimental than in a larger FUM vehicle (with consequently a more diversified loan book).

With respect to distributions, as noted there will be a Guaranteed Distribution in the first 12-months equal to 2.5% (net of fees and costs) paid monthly to investors that participate in the initial offer period. The Guaranteed Distribution is not in part a return of investor capital, rather any shortfall between interest from deployed capital and the 2.5% p.a. amount is funded by the 360 Capital Group (partly recouped by the payment of an MER on non deployed capital (cash) during the portfolio ramp up period). Thereafter, we would expect distributions to be in the vicinity of at least RBA Cash Rate + 4.0% (4.25% p.a.) and potentially materially higher.

The open ended structure tied with the nature of the investment strategy necessitates liquidity limitations. The Fund will be subject to a liquidity hard lock-up of 36 months post the offer open date (being 13 May 2023). Thereafter, unitholders will have the opportunity to redeem at the end of each subsequent six month period (in November and May). There is a one month notice period.

The liquidity structure, with a hard initial lockup period and subsequent restriction on redemption frequencies (for example every quarter end) and longer redemption notice periods, is common amongst private debt strategies. It is designed to 1) allow time to build capital and the portfolio, and 2) to better align the liquidity rights offered to investors with the liquidity of the longer term investment time frame and relatively illiquid nature of the underlying assets.

Investors should also note that while it is the Manager's genuine intention to honour its liquidity provisions, the Fund's PDS stipulates the RE can exercise discretion regarding limiting liquidity. Restrictions could conceivably be in the form of Fund-level gates (which enable the RE to limit redemptions up to an agreed percentage of the Fund's NAV) and investor-level gates (which allow the RE to limit redemptions by each investor up to an agreed percentage of that investor's investment in the Fund in each redemption period). Additionally, the RE would also have the right to suspend redemptions in certain circumstances (which, in practice, would only exercised as a very last resort). In IIR's view the ability to restrict redemptions is entirely appropriate given the nature of the strategy.

The Fund may borrow up to 30% of the Fund's gross asset value (GAV) to manage its liquidity. For example, for short term bridging finance for acquisitions or to meet working capital requirements and other short term obligations. The Manager does not currently intend to borrow funds to support core leverage within the Fund however, the Manager may borrow for liquidity and working capital purposes.

The NAV of the Fund is expected to be calculated monthly (although the Responsible Entity retains the discretion to calculate the NAV of the Fund quarterly or otherwise) by deducting from the total value of the assets of the Fund all liabilities, which includes declared but unpaid distributions, calculated in accordance with the AAS.

The MER is equal to 0.85% p.a. of the GAV of the Fund with total indirect recoverable costs estimated to be approximately 0.24% p.a (1.09% p.a. in total). Performance fees will be applicable to the enhanced return strategy (up to 30% of the portfolio).

Fund Structure

The Fund will be two registered managed investment schemes (Trust) comprising a Passive and Active trust stapled together. The diagram overleaf depicts the current structure of the Fund. 360 Capital Credit Income Fund is a stapled entity currently comprised of two Australian registered unit trusts being 360 Capital Credit Passive Income Trust (360 CCPIT) and 360 Capital Credit Active Income Trust (360 CCAIT).

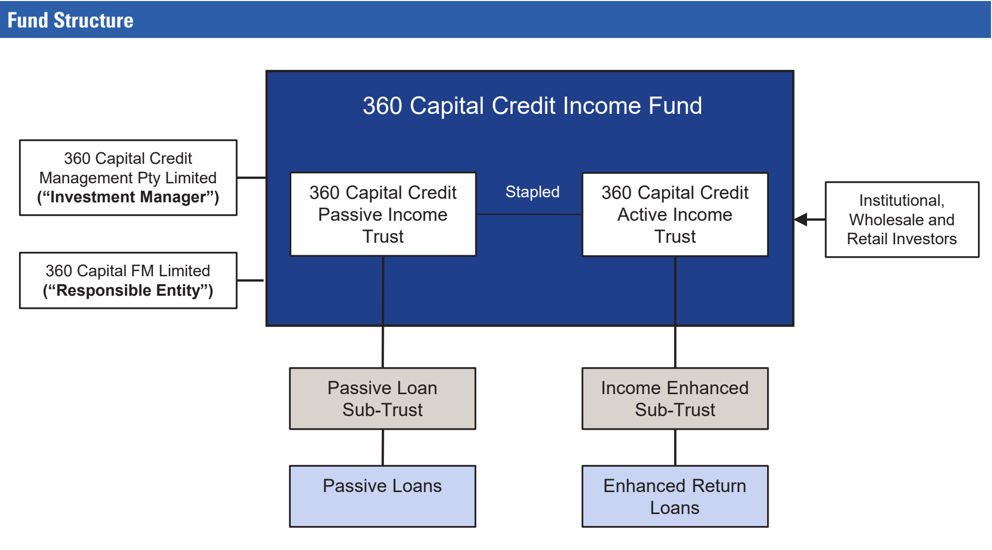
The structure provides a more tax efficient outcome for investors. In IIR's experience, this stapled structure is a commonly utilised structure in investment vehicles that make a combination of investments purely for income and investments that provide a combination of income plus capital returns.

The Passive trust will hold the majority of the underlying income producing debt investments, permitting a pass through of returns to investors on a non-taxed basis with the investor then responsible for managing their own tax affairs.

The Active trust provides CGT concessionary relief. The active trust will hold only those investments in which the Manager takes an equity stake and controlling operating position in any underlying investment. This is likely to be largely limited to three types of outcomes / investments: 1) loans which default and the Manager forecloses, thereby taking ownership of the underlying collateral (in the case where the collateral is cash flows of a borrower's business, ownership of the business itself); 2) Special Situations loans which include an equity component; and, 3) it also permits the Manager to potentially buy credit platforms in the future, rather than having to set up a separate investment vehicle.

The structure is diagrammatically presented below.

Fund Structure



360 CAPITAL GROUP

The Responsible Entity of the Fund is 360 Capital FM Limited. The Responsible Entity is a member of the 360 Capital Group. The 360 Capital Group is an ASX-listed (ASX: TGP), alternative asset investment and funds management group concentrating on strategic and active investment management of alternative assets. It was founded in 2006. As at the date of this report, 360 Capital Group has a market capitalisation of approximately $200 million, with approximately $500m in FUM. Approximately 35% of the 360 Capital Group is owned by staff and directors.

INVESTMENT TEAM

The direct investment team consist of Chris Chase (Head of Credit) and Mitchell Peasley (Investment Manager) and Scott Morgan (Origination Manager). The direct team are assisted most significantly by Credit Committee (CC) members Tony McGrath (founder of McGrathNichol) and Andrew Moffat (corporate and investment banking experience).

The direct investment team has an average of 20 years' experience covering origination channels across all market participants (banks, lawyers, advisers, accountants and proprietary broker network), credit diligence and underwriting, credit analysis and internal risk frameworks, and insolvency, restructures and workout. The investment team is well placed to capitalise on the increased borrower demand for non-bank lending in the low to mid-market corporate loan marketwhilst maintaining focus on downside analysis, capital preservation and loss minimisation.

There is a strong complementarity of skillsets and experience between the three member team. This is further augmented by Tony McGrath and Andrew Moffat, both of which also provide an important set of 'second eyes' on any given credit proposal and as a part of their IC duties.

While the team is small we do not believe it is stretched. Further, we would anticipate the 360 Capital Group may grow the team as the scale of the investment strategy grows if deemed appropriate. Additionally, the team is able to draw on the internal resources of 360 Capital in terms of various ancillary roles, enabling the Manager to largely purely focus on managing the investment strategy.

The key members of the investment team are detailed below.

- **Chris Chase, Head of Private Credit.** Chris joined 360 Capital in 2019 and is responsible for the development and execution of the groups diversified credit strategy. Chris has over 14 years experience in banking and corporate finance across Australia and Asia with significant experience originating and executing debt transactions in the mid-market.Chris has funded corporate M&A and growth capital across a range of industries including Healthcare, Telecommunications, Retail, Transport & Logistics, Business Services, Technology and Diversified Industrials. Prior to joining 360 Capital, Chris spent time at Macquarie Bank, CBA and ANZ within their Corporate Finance, Corporate Banking and Institutional businesses.Chris holds a Bachelor of Business (Finance & Accounting) from the University of Technology and is a CPA.
- **Mitchell Peasley, Investment Manager.** Mitchell joined 360 Capital in January 2020 and has 9 years experience in financial restructuring, corporate finance and the provision of mid-market corporate credit. Prior to joining 360, Mitchell spent 3 years with mid-market stressed and distressed lender and investor, Remagen Capital, where he gained extensive experience originating, structuring and executing complex transactions. Mitchell also gained experience in the provision of growth capital to mid-market borrowers across a range of sectors.Prior to Remagen Capital, Mitchell spent 6 years with THM Partners in London, and McGrathNicol in Sydney.Mitchell holds a Bachelor of Business (Finance and Accounting) from the University of Technology, is a CA and is a Level 1 holder of the CAIA program
- **Scott Morgan, Origination Manager.** Scott has 20 years' experience in credit investments and is skilled in strategy, deal origination, execution, management and investor relations. Prior to his current role, Scott was a Director with Newground Capital Partners responsible for originating real estate transactions, capital raising, fund management and reporting to investors.Scott has a Bachelor of Commerce from the Australian National University and holds a Graduate Diploma in Applied Finance and Investment from the Financial Services Institute of Australasia. He is also a Chartered Accountant and former Director of industry body, Property Funds Australia.
- **Tony McGrath, Independent Non-Executive Director.** Tony McGrath has over 33 years of experience in corporate markets specialising in restructuring and insolvency. Tony began his career at KPMG before founding McGrathNicol in 2004, leading the firm to become a prominent national restructuring, insolvency and advisory business. Throughout his career, Tony has undertaken some of Australia's largest and most complex insolvencies including HIH Group of Companies, Great Southern Limited and Pan Pharmaceuticals. Tony has been the Chairman of McGrathNicol since 2004 and is currently a director of QBE Insurance (Australia) Limited, Servcorp Limited and a Commissioner of the National Rugby League. Tony also serves on a number of Not-for-Profit boards.
- **Andrew Moffat, Non-executive Director.** Andrew has in excess of 23 years of corporate and investment banking experience, including serving as a director of Equity Capital markets and Advisory for BNP Paribas Equities (Australia) Limited. Andrew is the sole principal of Cowoso Capital Pty Ltd, a company providing corporate advisory services. Andrew is also a Director of Pacific Star Network Limited and a Director of ICP Funding Pty Ltd. His past public company directorships include Rubik Financial Limited, Keybridge Capital Limited, CCK Financial Solutions Limited, itX Group Limited and Infomedia Limited..

Investment Team & Investment Committee Personnel			
Name	**Position**	**Prior Relevant Experience**	**Ind. Exp. (yrs)**
Chris Chase	Head of Private Credit	Macquarie Bank, CBA, ANZ.	14
Mitchell Peasley	Investment Manager	Remagen Capital, THM Partners, McGrathNicol	9
Scott Morgan	Origination Manager	Newground Capital Partners	20
Tony McGrath	Independent Director	KPMG, McGrathNicol, Chairman / directorships	33
Andrew Moffat	Non-executive Director	BNP Paribas Equities, Cowoso Capital Pty Ltd, directorships	23

INVESTMENT PROCESS

Philosophy

The Fund has been established to provide investors with fixed income opportunities in the low to mid-market corporate lending market. Investors have generally been able to access over the counter (OTC) fixed income products, however, have historically had limited opportunity to invest in mid-market corporate credit, a part of the market generally reserved for wholesale and institutional investors and large financial institutions. With changing market dynamics, shifting risk appetite and a rise in regulatory costs and scrutiny, increasing opportunity exists for alternative capital providers to enter this market with flexible capital solutions to satisfy and support borrower demand.

The focus on first lien senior secured, which ranks ahead of any other type of debt in the capital structure in terms of priority of payment and security on assets and cash flows, reflects a strategic emphasis on lower credit risk, rather than stretching for yield. It reflects a strong focus on preserving investor capital.

This lower credit risk focus is reflected in the target return rate. While the Fund will invest in subordinated and mezzanine and some special situations, the Manager will not be tempted to move up the risk spectrum to any degree not consistent with the PDS, and as reflected in this report. The Manager is very mindful of a firm delineation of risk-return profiles and ensuring the Fund does not breach these, irrespective of how many attractive higher risk lends are available in the post COVID-19 environment (and there are many).

Further to the above, the Manager is currently of the view that it is unlikely to engage in subordinated / mezzanine and special situations lends until it reaches FUM in the vicinity of $500m. This reflects the Manager’s view that it is imprudent to do higher risk lends until a fund has the capacity and ability to absorb losses. For example, if a newly established fund with $100m in FUM were to incur a $15m loss on a riskier lend, the detrimental impact upon returns could severely undermine its efforts to raise additional capital.

The Manager is generally seeking to be a long term holder of its loans to its select borrower base, not simply a hold to the initial maturity date. For example, many loans may have an initial three year tenor. The re-negotiation period for such loans is generally two years, to avoid the debt being in the current liabilities section of the borrower’s balance sheet. Renegotiated loans may then be extended for a further three year period.

In this regard, the Manager is not seeking to recycle capital for yield. Rather, it is seeking to retain strong corporate borrowers over the longer term (for eg, 10 years). It is seeking to do so with low to mid market businesses in Australia with well-established and proven business models in industries with limited cyclicality, experienced through cycle management teams, stable earnings margins, sound operating cashflow and significant retained earnings and which have a core moderate leverage requirement (2 to 3x EBITDA) in their businesses. In short, the Manager is seeking to replace what the banks have done for the last 20 years, or so.

The Manager’s lending strategy incorporates a fundamentally driven credit investment philosophy which is based on detailed credit underwriting and financial analysis. For each credit, the Manager employs a bottom-up, fundamental due diligence process. The Manager seeks to understand every opportunity effectively from an equity perspective, seeking to understand a borrower’s business model and all matters pertinent to generating revenues and profits. The Manager will also establish multiple exit plans for a credit in the event and/or increasing risk of default and prior to executing a lend. A private debt lender ‘needs to understand where the back door is before walking in the front door’.

Given the nature of private enterprise in the mid-market sector, emphasis is placed on robust credit analysis and due diligence across financial and non-financial factors. The Fund utilises a variety of proprietary and third-party platforms to support credit assessment and risk rating and requires strong management engagement as part of its diligence process.

The Manager has a very proactive approach to structuring and managing its credits. It facilitates this by being either the sole-lender or bi-lateral lender. Or, in the case of club loans, being the lead or co-lead lender. This provides for greater transparency and deal control, with the potential to structure more favourable pricing, collateral, covenants, and other credit terms, in addition to greater control / influence in the event of a default and potential recovery / workout situation.

Investment Strategy

The Fund intends to access the corporate loan market through the following loan strategies: 1) Senior Secured Loans; 2) Subordinated and Mezzanine Loans; and 3) Enhanced Return Strategies (ERS). The longer term portfolio split between these three loan strategies is expected to gravitate around the following allocations: 85% senior secured; 10% mezzanine; 5% enhanced return.

Senior Secured Loans

Senior Secured Loans rank first in security over cash flow, assets and payments. Loans will be made directly to borrowers on a bi-lateral basis or syndicated basis. Senior secured loans will be agnostic to industry and may include rated and unrated borrowers. It is expected that the majority of senior secured loans will be to investment grade borrowers, at the equivalent of a B and BB credit rating.

For all Senior Secured transactions, the Fund will hold general security agreements over the fixed and floating assets of an entity and will not support transactions on a negative pledge basis. Negative pledge security on a standalone basis will only be considered for those borrowers with a strong credit rating or where the structure of the transaction does not permit the borrower to grant security to all lenders (i.e. in the event of a syndication).

Up to 100% of the GAV of the Fund may be invested in this loan strategy, and will likely be at this maximum level until sufficient FUM scale and portfolio diversification has been achieved. The Manager has stated that the former may be achieved ithe vicinity of $500m in FUM.

Subordinated and Mezzanine Loans

Subordinated Loan and Mezzanine Loans are junior or subordinated in priority to assets, security and cash flows to senior secured loans. Subordinated and mezzanine loans will be entertained with respect to businesses with strong cashflows, where the lend is also property backed and where there is significant equity buffer.

Industries will be limited to those considered defensive in their nature with the ability for borrowers to operate, or have demonstrated track record in operating through cyclicality, or with robust contract profiles with well rated counterparties that extend beyond the maturity of the loan term.

These opportunities may arise, for example where an existing bank lender is capped at a 50% LVR yet the borrower seeks an extra 10% LVR to 60% for specified purposes. They also need to be lends in which, if the Manager needed to take out the bank lender on the senior secured debt facility it would be comfortable doing so. In such a case, rather than simply holding the mezzanine component at, for e.g., a 10% interest rate the Manager would be hold the entire debt stack at a blended rate of 7.5% for example.

Enhanced Return Strategy (Special Situations)

The Enhanced Return Strategy (ERS), which more generally may be referred as special situation lends, will access a broad range of loan types and will include senior and subordinated loans. In some cases, the Fund will invest in loans where an equity-like instrument is included in the transaction structure (including convertible notes, options, warrants and preferred equity) and such instruments will comprise the ERS. It is anticipated that the ERS will generate higher yields, but as a result, assume a higher level of risk compared to the Senior Secured Loans and Subordinated and Mezzanine Loans within the portfolio.

Fund Strategy - Loan Characteristics			
Characteristic	**Senior Secured Loans**	**Subordinated & Mezzanine Loans**	**Enhanced Return Strategies**
Portfolio Weighting	50-100%	0-30%	0-30%
Target Loan Returns (IRR)	4 - 8%	8-15%	>15%
Risk Profile	Low	Low-Medium	Medium
Typical Loan Size	$5M - $30M	$5M - $20M	$2M+
Credit Quality	Investment & Sub-Investment Grade	Sub-Investment Grade	Sub-Investment Grade
Typical Loan Leverage	2x – 4x	3x – 5x	Various
Term	3 - 5 Years	1 – 3 Years	6 months +
Security	1st Ranking GSA 1st Mortgage	2nd Ranking GSA Intercreditor Agreements	2nd Ranking GSA Warrants, Options, Preferred Equity

Fund's Investment Guidelines	
The Investible Private Debt Universe	• Corporate finance • Growth capital • Acquisition finance • Event driven finance • Transformational capital • Bridging finance
Investment Characteristics	• Senior, Subordinate / Mezzane and Special Situations (the latter two subject to sufficient FUM scale and portfolio diversification) • Rated or unrated by a credit rating agency (Moody's shadow rating) • Cash, payment-in-kind (PIK) interest • Tenor 3-5 years, with the Manager seeking to renegotiate and extend loan term for strong borrowers thereafter • Strong asset backing and or recurring, stable cash flows
Location	• Investments will be primarily connected to or have their principal business located in Australia and New Zealand
Maximum Exposures	• Borrowers: Credit to a variety of public and private companies, and no more than 10% of the Fund assets will be invested in a single borrower group, subject to full portfolio ramp up • Industries: Credit across industry sectors and no more than 20% of the Fund's investments will be in a single industry, subject to full portfolio ramp up
Asset Duration	The Fund will invest in loans with a maximum term to maturity of five years, unless otherwise agreed by the Credit Committee. Loans are assessed to ensure clear exits at the end of the loan term. To facilitate liquidity, notwithstanding the fact that there is an active secondary market for certain types of private debt, the Manager seeks to diversify by term to maturity and targets a weighted portfolio loan tenor of 3.0 years.

Corporate lending, secured by cashflows, may be undertaking on a sole lending basis by the Manager (where the loan size does not introduce undue portfolio construction risk) or on a club syndicated basis (where the total loan is split between multiple borrowers). In the case of syndicated lending, it is the Manager's intention to take either a lead or co-lead role. Being either the sole-lender, lead or co-lead lender in a corporate lending deal (as opposed to simply a syndicate member) provides for greater transparency and deal control, with the potential to structure more favourable pricing, collateral, covenants, and other credit terms, in addition to greater control / influence in the event of a default and potential recovery / workout situation.

A certain percentage of corporate lending deals are expected to be private equity (PE) sponsor backed. That is, where a private equity firm is the owner of the business and seeks to partly leverage the business through a debt facility. It is expected that this component of corporate lending deals is unlikely to exceed 15% of the total portfolio. This limit reflects the Manager's view that with PE sponsored deals it is often more difficult to control the structuring of a deal.

As consistent with the private debt market, most loans are expected to be floating rate instruments based on an interest rate spread over the 90-day BBSW rate and which may be periodically reset. Broadly speaking, the spread is a function of credit quality and market-based factors, specifically the illiquidity premium and market supply and demand. Interest rate floors will typically apply, mitigating returns risks should the RBA implement a further 25 bps to the RBA Cash Rate.

Returns to investors in the Fund will be in the form of income from the Fund's deployed capital to borrowers comprising: 1) floating rate interest payment coupons; 2) interest payments may be structured in the form of a Payment In-Kind (or PIK), which accrues on a current basis but is generally paid later, often at maturity; 3) up-front "fees," principally in the form of original issue discount or "OID" (the difference between the issue price and the par value of the debt, noting that the Manager may determine fee sharing arrangements with the Fund and other related parties at its discretion); 4) fees and other penalties on

early repayments from borrowers; 5) less any ancillary costs to running the Fund, and; 6) a potential diminution of income should losses be incurred through a default event and a recovery rate less than par value.

The Manager seeks to ensure adequate structural protections and portfolio diversification. Investments are typically characterized by highly negotiated, customized covenant packages. It seeks structural protections such as strong protective covenants, mandatory amortizations (excluding some PIK structures) and free cash flow sweeps in order to limit the downside risk that is commonly associated with illiquidity. Being the sole, lead or co-lead lender in the majority of investments provides greater control in negotiating protections. This is in contrast to simply being a deal participant in which case a participating lender may simply be 'piggy backing' off the sourcing lender and being a price taker.

Credit Assessment and Management Process

The loan assessment and management process undertaken by the Manager is diagrammatically presented and detailed below.

Credit Assessment and Management Process

Origination → Due Diligence → Credit Committee → Investment Committee → Financial Close → Portfolio Monitoring

Origination / Due Diligence	Credit Committee / Investment Committee	Financial Close / Portfolio Monitoring
•Market sourced transactions with banks, advisers, accountants and intermediaries •Transaction structuring and financial modelling •New transaction brief to management team for indicative support •Term sheet negotiations and mandate •Detailed Financial modelling and downside analysis •In depth management discussions •Market participant scanning and consultation •Third party due diligence including financial, tax, legal and operational	•Preparation of Credit Submission for Credit Committee •Description of transaction, investment analysis, due diligence findings, risks & mitigants •Presented to Credit Committee for Endorsement to Investment Management Board •Appropriateness of investment considered in light of overall fund return, capital availability, risk profile and alignment with fund strategy	•Externally prepared legal documentation in the form of Facility Agreement •Negotiations on terms and conditions with external counsel •Execution of necessary security documents including Registered Mortgage and Specific Security Agreements •Proactive investment monitoring •Ongoing relationship management with borrowers including regular management meetings •Monitoring of compliance with financial covenants and key terms •Quarterly Investment Management Board portfolio reviews

Origination. Loans are sourced from a variety of external sources including major banks, brokers, loan originators, legal, advisory and accounting firms, and PE sponsors. Chris and Mitchell, having been engaged in the private lending segment for an average of 11 years, has established firm relationships and will rarely use an origination source outside this network of established relationships. This provides a degree of pre-qualification for any deal, with the Manager having a level of trust in the due diligence already undertaken by such parties. In many cases, these origination sources have had a pre-exising relationship with the prospective borrower for many years and have a vested interest in executing a solution for the client, i.e. there is a degree of 'ownership'. Furthermore, many such relationships have been over a multi-year period, assisting the quality of information provided by the origination source to the Manager.

Generally speaking, a wide and strong deal sourcing network is an important element of a successful private debt strategy. It creates a strong deal flow, enabling an investment manager with thorough underwriting processes to deploy capital in a sufficient time frame without comprising underwriting standards or portfolio quality. It also provides access to non-competitive, or less competitive opportunities, better information flow and often from trusted parties based on existing relationships, greater diversity in counterparties, greater role flexibility in each transaction (lead, co-lead, follower), and greater say in negotiated terms.

Further to direct private enterprise lending, the Fund may enter into loan arrangements with private equity sponsors, to assist with their investment refinancing, acquisition funding and growth capital.

Investment Evaluation. The Manager undertakes a two stage evaluation process. The being an initial screen based on a strict investment criteria and an assessment of the quality of the security and degree of capital protection. For potential lends that pass this process, a detailed due diligence is conducted.

As noted previously, the Manager's lending strategy incorporates a fundamentally-driven credit investment philosophy which is based on detailed credit underwriting and financial analysis. For each credit, the Manager employs a bottom-up, fundamental due diligence process. The process is broadly divided into company and market due diligence, gaining a clear understanding of security quality, and determining exit options / strategies should a credit deteriorate.

Company due diligence focuses on understanding the quality of cash flows of the underlying investment, including requirements for growth, degrees of flexibility to reduce costs and requirements for debt amortization. It includes an assessment of the strengths and weaknesses in a company's cost structure, cost structure relative to competitors, and quality of suppliers.

The process generally entails management meetings, site visits, and, where required, calls with suppliers and customers. External consultants and third party industry diligence may also be included where additional external input is deemed prudent in relation to the industry the potential borrower is operating in.

Loan Terms and CC Review. For those transactions that pass preliminary screening, due diligence materials and conclusions (both internal and external) are compiled into a formal credit paper and referred to the Fund's CC and Investment Management Board for loan approval. The Fund's CC comprises independent members with significant corporate and risk management experience. The CC's primary role requires detailed assessment of the credit paper and associated diligence material.

Following endorsement of the proposed loan from the Fund's CC, investment opportunities are referred to the Investment Management Board for final approval. The Investment Management Board opines on the suitability of the lend.

Credit and Portfolio Monitoring. Credit performance and portfolio level risks and exposures are reviewed on an ongoing basis by the Manager and formally on at least a semi-annual basis by the CC.

IIR would characterise the Manager has high touch with respect to the performance of each individual credit. There is an advantage in originated direct lending investments over broadly syndicated debt instruments or public debt. Specifically, it enables an informational advantage in which to monitor and mitigate investment risks.

Given the private, negotiated nature of these investments, lenders such as the Manager are able to access frequent borrower performance reporting which, combined with other negotiated terms in these arrangements, can enable lenders to assert influence over a borrower's business and identify early signs of credit deterioration.

Portfolio Construction

The table below summarises the internal risk management guidelines at a whole of portfolio level, noting that these guidelines are subject to change at the Manager's discretion. These guidelines appear appropriate to IIR, although we would expect the actual level on asset backed and property security to be materially below the maximum thresholds detailed below.

Portfolio Parameters

Credit Parameters	Description	Sub-description	Max Threshold
Leverage	Debt / EBITDA	Asset backed (> 1.25x)	< 5.00x
		Cash Flow (contract backed)	< 4.00x
DSC*	EBITDA / P&I		> 1.25x
ICR**	EBITDA / Interest		> 1.50x

* Debt Service Cover. ** Interest Cover Ratio

While the Fund is newly formed, to facilitate the timely deployment of funds raised the Manager has reviewed to varying degree approximately $500m worth of potential investment opportunities (current pipeline of potential deals). IIR does not at all expect deal flow to be a constraining factor for the Fund.

The initial pipeline assets may or may not form part of the assets of the Fund. The Fund will continue to source investments which meet its investment objective and investment strategy, however, during the ramp up phase of the Fund, the pipeline of investment

opportunities may not be representative of the target investment guidelines. The Manager anticipates the ramp up phase will be for a period of up to 12 months.

That said, the Fund will most likely have portfolio diversification risk over the first 6 to 12 months subject to FUM raise levels. But as an indication, the Manager is confident it can raise an amount that would enable it to do 10 loans at a per lend average of $15m and which it envisages it could deploy within six months. The Manager has a single lend and industry limit of 10% and 20% respectively, which it may well exceed during the first 12-months, but diversification would naturally increase thereafter based on subsequently capital raises.

Fund Inflows Management

The open ended structure is designed by substantially mitigate the cash dilution risk inherent in the close-ended structure and, more importantly, the requirement to quickly invest large sums of money raised through an IPO or secondary capital raise.

Rather than raise a large amount of capital through a one-time raise at the inception of the fund (and diluting yields during the period required to become fully invested), the open-ended structure permits the Manager to conduct periodic capital raisings and, hence, raise a lesser amount per raise compared to the close-ended vehicle. Yield dilution risk can be greatly reduced due to the shorter time frame to fully invest the new capital.

The key to the mitigation of yield dilution risk is in the management of the process. Subsequent to the initial raise, we would expect the Manager to adopt an approach of calibrating subsequent raise amounts with what it can confidently invest over a six monthly time frame based on its existing pipeline of loans.

More importantly, however, is this periodic approach to raising capital and an amount calibrated with contracted and prospective credit lends means the risk that prudential lending standards that could otherwise deteriorate for a manager under pressure to invest large amounts of capital in a timely fashion is effectively removed.

Valuation

In a post COVID-19 era, private debt fund managers need to be particularly vigilant in following their valuation policies and, when appropriate, updating valuations, possibly on a more frequent basis than ordinarily would be the case.

Furthermore, a reassessment of the existing weightings of different valuation methodologies may be prudent in cases where precedent transaction analysis may not reflect the most current market information.

The latter is particularly important for open ended vehicles, and especially for those that offer redemption liquidity (not relevant for the Fund until year 3 anniversary). Why? Because if valuations are over-stated relative to market transaction levels, new investors run the risk of effectively over paying where published NAV is greater than a valuation based on market valuations, thereby effectively subsidising existing unitholders. The converse applies with respect to redeeming investors - they are effectively being subsidised by remaining investors. Neither of the two situations are ideal, creating 'inter-generational' wealth transfer inequalities.

While recognising that private debt managers are generally hold to maturity investors in respect to each loan, in periods of market dislocation managers may be forced into secondary market sales of a component of a loan book, and possible in funding redemptions. This increases the importance on up-to-date valuations as well shifting the existing weights of various valuation methodologies to be based more on recent market transaction values.

There are no hard and fast rules about valuation which, as has become evident with some industry based Super funds, reduces transparency and confidence in addition to wealth transfer issues. Furthermore, IIR's understanding is private debt managers generally do not factor in a collective default provision, as banks are required by regulation (generally 1-3%), thereby arguably overvaluing a loan book.

PERFORMANCE ANALYTICS

While the Fund does not have a track record and the strategy is newly formed within the 360 Capital Group, IIR gains confidence with respect to the Manager seeking to address these risks by: 1) being highly selective with loan investments; 2) ensuring strong loan protections and information flow from borrowers; 3) having the resources to take action should the credit

deteriorate; and, 4) by targeting companies with strong cash flows with proven through cycle business models and management and adopting strong levels of security.

- The two key team members of the investment team have an average of 11 years' experience covering origination channels across all market participants (banks, lawyers, advisers, accountants and proprietary broker network), credit diligence and underwriting, credit analysis and internal risk frameworks, and insolvency, restructures and workout.
- From a risk perspective, it is important to note that the vast majority of lends will be based on a first ranking security over cashflows and potentially secured assets and/or. The focus on first lien senior secured, which ranks ahead of any other type of debt in the capital structure in terms of priority of payment and security on assets and cash flows, reflects a strategic emphasis on lower credit risk, rather than stretching for yield, and a focus on preserving capital.
- Corporate lending, secured by cashflows, may be undertaken on a sole lending basis by the Manager (where the loan size does not introduce undue portfolio construction risk) or on a club syndicated basis (where the total loan is split between multiple borrowers). In the case of syndicated lending, it is the Manager's intention to take either a lead or co-lead role. Being either the sole-lender, lead or co-lead lender in a corporate lending deal (as opposed to simply a syndicate member) provides for greater transparency and deal control, with the potential to structure more favourable pricing, collateral, covenants, and other credit terms, in addition to greater control / influence in the event of a default and potential recovery / workout situation.
- IIR notes that the 360 Capital Group has sufficient financial restructuring and operational turnaround experience. It adopts a proactive approach to portfolio management and will step in early if an investment shows signs of credit deterioration through adverse operational developments. The Manager has the ability to leverage the operational expertise of the CC to assist the company in implementing operational improvements if needed.

APPENDIX: THE AUSTRALIAN PRIVATE DEBT MARKET

The private debt market in Australia is an $2.8 trillion market, bigger than the ASX 200 Index and Australia's total superannuation pool. It is a market that has experienced strong, year on year growth over the last 15 years with total private credit market experiencing a compound annual growth rate (CAGR) of 7.6% and the corporate loan market experiencing a CAGR of 5.9%.

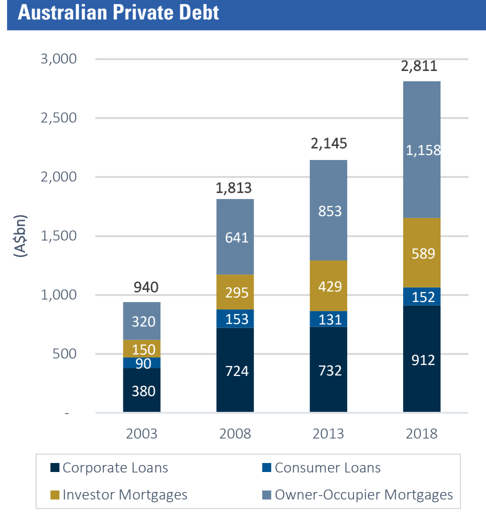
Changes to regulatory and prudential regimes has seen major Australian authorised deposit taking institutions (ADIs) tighten lending requirements and in some cases, reduce or withdraw offering credit particularly to mid-market corporates and SMEs. Furthermore, while ADIs may have been generating attractive yields from such lending activities, the need to allocate capital against such lending activities has meant the actual level of returns are substantially less.

This has created significant demand with non-bank sourced funding now overtaking ADI sourced funding for mid-market corporates and SMEs. These entities are not required to allocate capital against the same lending activity. A case in point is the withdrawal of Westpac in 2019 from equipment finance and leasing which previously managed a multi billion lending book in the segment.

The private debt market has substantial barriers to entry which make it difficult for non-bank lenders to participate and is traditionally the domain of ADIs. Those non-bank lenders who can overcome the barriers to entry are meeting the growing demand and providing wholesale investors exposure to this market.

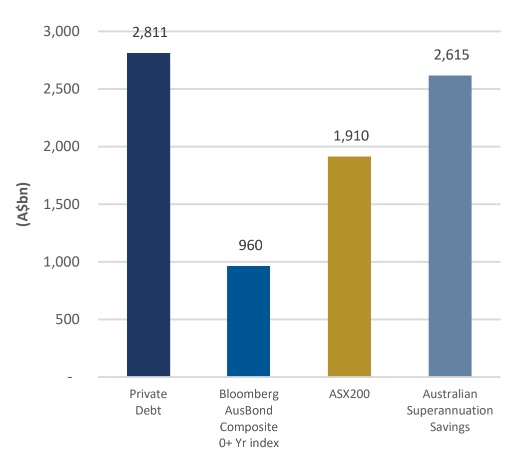
In the current and post COVID-19 period, IIR believes this trend of flow away from banks to non-bank lenders in the mid-market corporate lending sector is likely to accelerate. Additionally, we expect pricing to borrowers to increase. Refer to the 'Low to Mid-Market Direct Lending in a Post COVID-19 Environment ' section for the rationale for these views.

Australian Private Debt

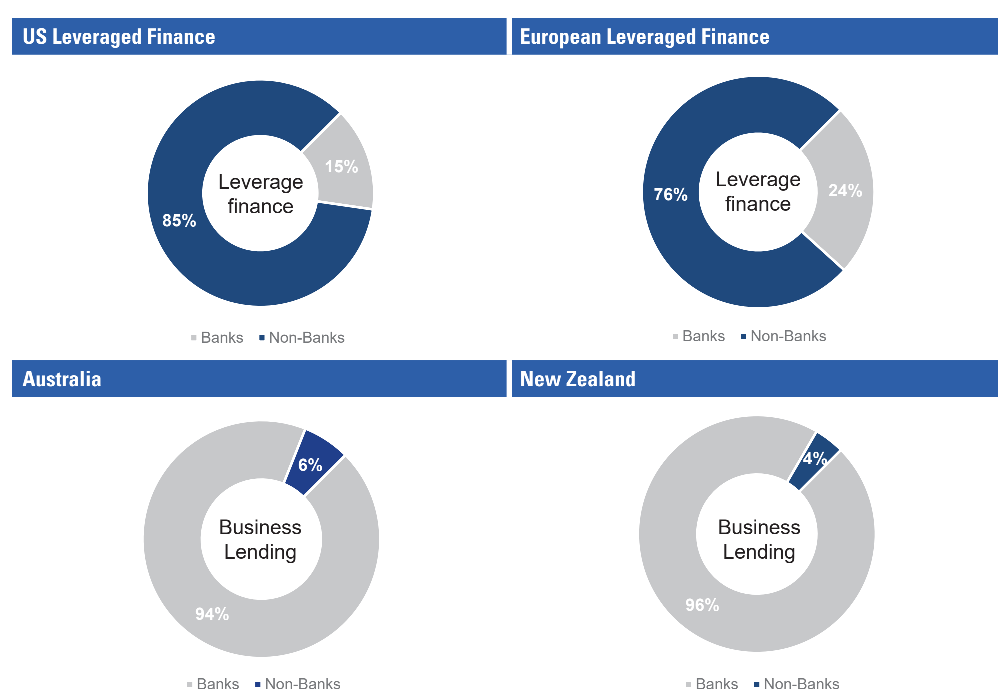


Source: Source: Reserve Bank of Australia, 360 Capital

Relative Size of the Australian Private Debt Market



Source: Source: ASFA, RBA, ASX, Bloomberg, 360 Capital



Features of the Australian Private Debt Market

Factor	Australia	Sector Focus
Current Market Landscape	Growing number of non-bank institutional and private lenders but remains bank-dominated Secured (senior, stretch senior, unitranche and mezzanine) Illiquid with secondary trading the exception not the norm	Deep secondary market Highly illiquid Secured / Unsecured Increased volatility
Typical Structures and Covenant Packages	Super Senior structures without control Mandatory debt repayment on asset sales Covenant packages are commencing to trend towards the European and North American models, although still tight relative to global standards for Term Loan B (TLB) market Unitranche structures more visible in the mid-market and SME market	Covenant lite and no covenant loans are standard (particularly in the TLB market) Additional indebtedness widely accepted Removal of lender consent on asset sales is common

The table above identifies the main differences between the Australian debt markets and those in the US and Europe. The market structure differences mean that the Australian market is substantially less efficient; thus, lenders hold significantly more control and can set more favorable structural and covenant terms.

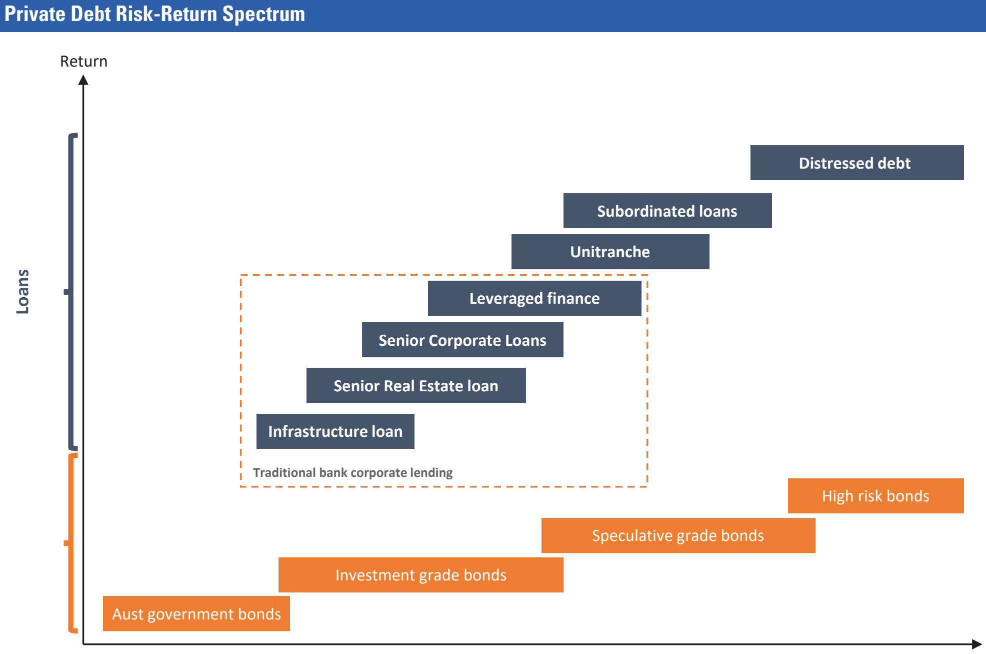
The differences between these markets are also manifested in pricing. The lack of institutions in the Australian markets means that higher quality credit can offer a significant premium and, unlike in the US and European markets, has not historically suffered from yield compression or cyclical volatility.

In our experience, Australian bank loans also tend to offer a significant spread premium over North American and European bank loans of a similar risk profile. Pre COVID-19 single B transactions in Australia were typically priced between 500-800bps over floating, whereas the single B markets in the US and Europe were transacting at around 350-450bps over.

This pricing premium in Australia has broadly stayed consistent and at a significant premium throughout the past decade, primarily due to the private nature of the lending market and the dominance of banks as providers of loans, meaning borrowers are left with limited options.

There are other reasons for sophisticated, institutional investors to consider the Australian private lending market. Private lending activities within the Australian economy dwarf the activity in the bond market. In fact, commercial lending as 'bank loans' were approximately 22.8x larger than the domestic corporate bond universe. In addition, the private debt markets are a much better reflection of actual economic activity. The bond markets are almost always a reflection of big issuers and their ability to achieve high grade credit ratings. From a diversification perspective, we believe the opportunities within the private lending environment significantly outweigh those on offer from bond markets.

Private Debt Risk-Return Spectrum



Low to Mid-Market Direct Lending in a Post COVID-19 Environment

The leveraged loans market simply represents the primary issuance of broadly syndicated loans (BSL) to generally large to very large companies which are then sold on the secondary market (the leveraged loans market) by BSL participant lenders. The leveraged loans market largely comprises BSLs originated in North America and Western Europe. BSLs differ to direct lending in that the latter may be executed on a direct lend or club lend basis and are rarely if at all sold on to the leveraged loans market by way of a secondary sale.

Over the past year or so, the leveraged loan market has been subject to significant negative press. There was good reason for this. On the whole, this market had a very risky investment philosophy: stretch on credit risk in pursuit of higher yield. As competition intensified in the direct lending market – particularly in the larger company space with loans of $100 million and upwards – and as yields declined, lenders in the leveraged loan market adopted a more laissez-faire attitude when it came to upholding high credit standards.

As direct lending continued to flourish following the GFC, corporate lenders began to loosen their investment discipline in order to win new deals and maintain robust deployment numbers amid increased head-to-head competition from direct lending. Lenders started to provide surplus leverage to large borrowers, further fueled by aggressive EBITDA addbacks. They also began to eliminate financial covenants and set up very borrower-friendly structures ('cov-lite'). Some of these structures left lenders unprotected from collateral transfer and open to certain 'accordion' features, which gave borrowers the power to draw more debt from the lenders in future without additional consent.

Up until COVID-19 placed an abrupt halt to daily life and shuttered businesses around the world, the direct lending environment was unquestionably borrower-friendly. Many lenders saw leverage levels increase to 6x or more and loan-to-value ratios increase to 60 percent and beyond. As a result, cash interest coverage ratios declined. Risk mitigating mechanisms, typically synonymous with an investment in a first lien loan in the US, were disregarded. Most of these loans lacked a full package of quarterly financial covenants, which are key in the measurement of, and timely reaction to, company performance and used to be standard for first lien paper. When there are no covenants in place, the lender is unable to take any action until the company defaults on its interest payments. By the time that happens, the company and the lenders are both in trouble.

Lending to performing companies was designed to be an asset class that provided predictable and stable yields with built-in safety protections to furnish steady returns during market booms and ensure capital preservation during market declines. Moreover, when a bubble is building, mitigating downside risk should be paramount. But downside risk protection against even a moderate recession was not a priority for many lenders. Worse, COVID-19 arrived without warning and wreaked havoc on the markets. This year, we have seen wild and unprecedented swings in the public equity and fixed-income markets.

With the first quarter now behind us, the question is how will the private lending market evolve in terms of existing portfolio valuations, covenant breaches and recovery rates?

Private equity firms and lenders alike will see a decline in valuations for Q1 and probably for Q2. This will be especially so for those exposed to sectors hit hard by the pandemic (such as airlines, hospitality and energy) and, to a somewhat lesser degree, businesses in the US that have been mandated by state governments to temporarily close (location-based product or service companies). If the result of COVID-19 winds up being a full-blown recession in the US, then many more businesses will be affected.

Lenders that aggressively levered up their borrowers' balance sheets and created covenant-lite structures in the pre-covid deal environment will no doubt see payment defaults spike, losses pile up and recovery rates fall at higher rates than those that lent at much more conservative levels.

Also hard-hit will be those lenders that had a high percentage of non-sponsored transactions. In those cases, it will be the lenders (and not the equity sponsors, as will be the case in sponsored transactions) that will need to provide all the rescue financing and take on the burden of ensuring companies are able to withstand this period of pain.

The Outlook for the Low to Mid-Market remains Solid

One area IIR believes that will continue to do well is the lower mid-market (loan sizes just below $50 million). These corporate borrowers are large enough to have sufficiently strong underlying characteristics to be a safe credit risk, and have credit ratings on a par with or perhaps better than those at the higher end of the mid-market due to lower leverage levels. The level of safety one would have otherwise assumed when investing in a large company has been diminished by the high level of risk created through aggressive leverage levels, no covenants and limited rights when the company underperforms. This has made the very large loan a very risky one.

The lower mid-market had less competition before COVID-19, and lenders in this space had more rights than those in the core mid-market. As such, lower mid-market lenders were able to maintain lower leverage levels (3-4x compared with 5.5x or more in the core mid-market), lower loan-to-value ratios (40 percent versus 60 percent or more) and keep EBITDA addbacks at bay. Lenders in this space are also able to manage loans actively by requiring board observer seats, monthly and quarterly financial statements, quarterly compliance certificates and annual independent audits. Superior visibility into borrower performance coupled with control of the loan voting rights allows the lender to exercise its rights early on in order to firmly address problems before they result in payment defaults or loss of principal. Many of these characteristics have been unavailable in the larger loan market.

Although no lender will be left unscathed by the pandemic, those that will persevere are the ones that have insisted on three things: low leverage levels to withstand a steep decline in earnings; those that lent on a prudent basis on a bi-lateral or lead role or, alternatively, established partnerships with private equity firms that are willing to support companies by infusing additional equity capital; and abundant lender rights that did not recede during the benign economic environment of the last few years.

As this downturn plays out, we will be left with a direct lending landscape of few players as managers with overleveraged portfolios fall away due to performance and liquidity issues as they manage broken portfolios.

One significant impact of COVID-19 will be a change in the direct lending market that will mirror the years following the GFC, when credit was strained and therefore extremely expensive once it had been procured. This will create attractive opportunities for direct lenders in Australia.

Lenders that created a portfolio full of loans to good-quality businesses at responsible levels of leverage and full covenant protections will not be hindered by severe illiquidity resulting from distressed portfolios that were built over the last few "boom" years. Instead, they will be able to deploy dry powder in a disrupted market that will be very attractive for lenders.

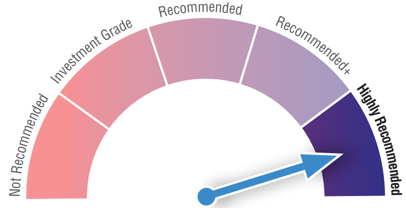
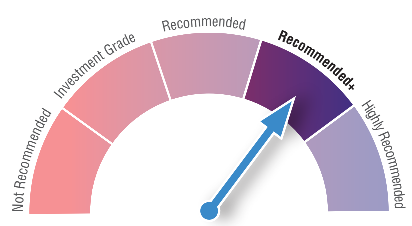
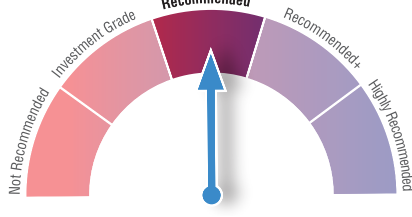
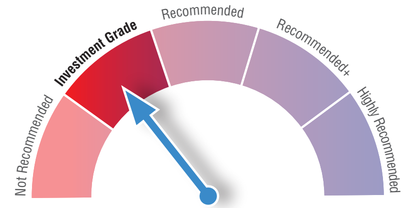
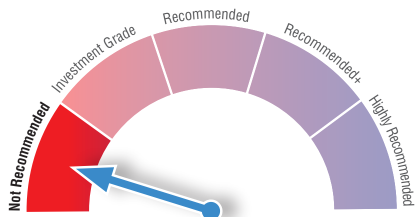
In the Australian market, IIR believes the trend of lending flow away from banks to non-bank lenders in the mid-market corporate lending sector is likely to accelerate. Additionally, as quality businesses look for loans in a credit-strained market, lenders will demand higher pricing. These views are based on a range of factors, including:

- Banks are currently under significant workload stress and are likely to be for the next few years, which is likely to lead to deteriorating service levels and prolonged debt issuance timeframes for existing and potential new borrowers. The private credit market will have a real role to play in ensuring that there is still liquidity in the system for some of those borrowers;
- Over the last 10-year bull market banks have shed and reduced their workout capability internally quite drastically as well - there is likely to be an inability from a resourcing and skills perspective to work through deteriorating credits, opening up further deal flow ton non bank lenders in potentially heavily discounted credits.
- The pricing gap between bank and non-bank credit to the low-mid-market corporate segment has compressed significant over the last six months, or so, from a rough average of 300 basis points down to 100 basis points. A significant contributor to this has been the decline in the RBA Cash Rate, which adversely affects banks margins. Banks have been repricing their loan margins from what has historically been 150 - 200 bps to more like 200 - 300 bps. This is causing borrowers to look to certain non-bank lenders that can provide better structural terms and conditions, provide faster loan completion timeframes and show longterm support to the borrowers.

APPENDIX A – RATINGS PROCESS

Independent Investment Research Pty Ltd "IIR" rating system

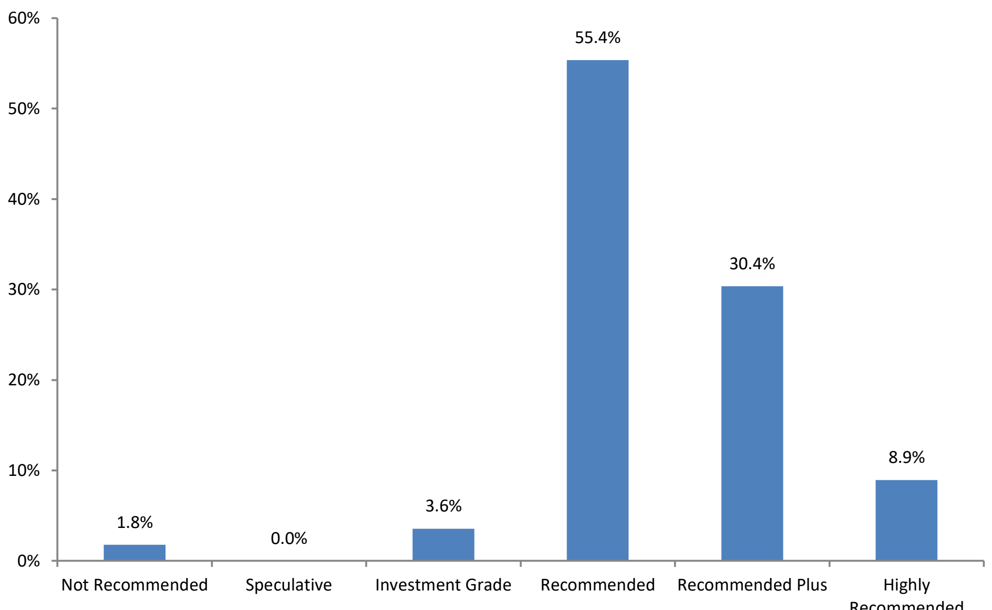
IIR has developed a framework for rating investment product offerings in Australia. Our review process gives consideration to a broad number of qualitative and quantitative factors. Essentially, the evaluation process includes the following key factors: management and underlying portfolio construction; investment management, product structure, risk management, experience and performance; fees, risks and likely outcomes.

LMI Ratings	SCORE
Highly Recommended	**83 and above**
	This is the highest rating provided by IIR, indicating this is a best of breed product that has exceeded the requirements of our review process across a number of key evaluation parameters and achieved exceptionally high scores in a number of categories. The product provides a highly attractive risk/return trade-off. The Fund is likely effectively to apply industry best practice to manage endogenous risk factors, and, to the extent that it can, exogenous risk factors.
Recommended +	**79–83**
	This rating indicates that IIR believes this is a superior grade product that has exceeded the requirements of our review process across a number of key evaluation parameters and achieved high scores in a number of categories. In addition, the product rates highly on one or two attributes in our key criteria. It has an above-average risk/return trade-off and should be able consistently to generate above average risk-adjusted returns in line with stated investment objectives. The Fund should be in a position effectively to manage endogenous risk factors, and, to the extent that it can, exogenous risk factors. This should result in returns that reflect the expected level of risk.
Recommended	**70–79**
	This rating indicates that IIR believes this is an above-average grade product that has exceeded the minimum requirements of our review process across a number of key evaluation parameters. It has an above-average risk/return trade-off and should be able to consistently generate above-average risk adjusted returns in line with stated investment objectives.
Investment Grade	**60-70**
	This rating indicates that IIR believes this is an average grade product that has exceeded the minimum requirements of our review process across a number of key evaluation parameters. It has an average risk/return trade-off and should be able to consistently generate average risk adjusted returns in line with stated investment objectives.
Not Recommended	**<60**
	This rating indicates that IIR believes that despite the product's merits and attributes, it has failed to meet the minimum aggregate requirements of our review process across a number of key evaluation parameters. While this is a product below the minimum rating to be considered Investment Grade, this does not mean the product is without merit. Funds in this category are considered to be susceptible to high risks that are not reflected by the projected return. Performance volatility, particularly on the down-side, is likely.

APPENDIX B – MANAGED INVESTMENTS COVERAGE

The below graphic details the spread of ratings for managed investments rated by Independent Investment Research (IIR). The managed investments represented below include listed and unlisted managed funds, fund of funds, exchange traded funds and model portfolios.

SPREAD OF MANAGED INVESTMENT RATINGS



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